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In the Supreme Court of the United States

OCTOBER TERM, 1974

No.

SECURITIES AND EXCHANGE COMMISSION, PETITIONER

v.

WILLIAM V. COFFEY and JOHN M. KING

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

The Solicitor General, on behalf of the Securities and Exchange Commission, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Sixth Circuit which reversed an order granting injunctive relief to the Commission.

OPINIONS BELOW

The opinion of the court of appeals (Appendix A, *infra*, pp. 1a-29a) is reported at 493 F. 2d 1304. The opinion of the district court granting a temporary restraining order and denying applications for

stay of proceedings (Appendix B, *infra*, pp. 30a-94a) is reported at 351 F. Supp. 236. Its opinion granting the permanent injunctions (Appendix C, *infra*, pp. 95a-97a) is not reported.

JURISDICTION

The judgment of the court of appeals (Appendix D, *infra*, pp. 98a-99a) was entered on March 28, 1974, and a timely petition for rehearing and clarification of opinion was denied on July 2, 1974 (Appendix E, *infra*, p. 100a). On September 17, 1974, Mr. Justice Stewart extended the time for filing a petition for a writ of certiorari to and including November 29, 1974. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether, to establish violations of the antifraud provisions of the federal securities laws as a predicate to obtaining injunctive relief, the Securities and Exchange Commission must show that (a) the defendants acted in "wilful or reckless disregard for the truth" and (b) the party against whom the misrepresentations were directed was actually deceived by them.

STATUTES AND RULE INVOLVED

Sections 17(a) and 20(b) of the Securities Act of 1933, 48 Stat. 84, 86, as amended, 15 U.S.C. 77q(a) and 77t(b), Sections 10(b) and 21(e) of the Securi-

ties Exchange Act of 1934, 48 Stat. 891, 900, as amended, 15 U.S.C. 78j(b) and 78u(e); and Rule 10b-5 under the Securities Exchange Act, 17 C.F.R. 240.10b-5, are set forth in Appendix F, *infra*, pp. 101a-103a.

STATEMENT

The Securities and Exchange Commission seeks review of the decision of the court of appeals that reversed injunctions against defendants found by the district court to have violated the antifraud provisions of the federal securities laws. The Commission brought this action pursuant to Section 20(b) of the Securities Act and Section 21(e) of the Securities Exchange Act in the United States District Court for the Southern District of Ohio against 19 individual and corporate defendants, including respondents William V. Coffey and John M. King, who were respectively the financial vice-president and board chairman of King Resources Company.[1] The Commission charged that in the offer and sale of $8,000,000 of two-year promissory notes of King Resources Company to the State of Ohio, the defendants had violated antifraud provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934.

Under Ohio Revised Code § 135.14 (Appendix B, *infra*, pp. 39a-40a, n.7) the state treasurer is authorized to invest "interim moneys" in, *inter alia*, corpo-

[1] Of the other 17 defendants, 16 consented to the entry of permanent injunctions and the action was dismissed against King Resources Company on grounds of *res judicata*.

rate commercial paper rated "prime" by the National Credit Office, Inc., a division of Dun & Bradstreet. Through certain intermediaries, King Resources obtained a "prime" rating from the National Credit Office and sold the State of Ohio two two-year promissory notes totalling $8,000,000. Shortly after the sale, King Resources collapsed financially, rendering the notes virtually worthless. (Appendix A, *infra*, p. 3a.)

The Commission alleged that the notes had been sold through misrepresentation with respect to the "prime" rating, since the notes in question were not, and could not be, rated "prime" because that rating is not applicable to two-year notes; and through the failure of King Resources to disclose that it was not meeting its obligations to creditors as they matured and that substantial portions of the loan proceeds were not to be used by King Resources but were to be re-loaned to others, including Colorado Corporation, which King and his family controlled (*id.* at 3a).

The district court held that the use of the term "prime" in connection with the sale of two-year notes, regardless of how or why the rating was obtained, was fraudulent because it would tend to mislead and confuse purchasers.[2] It enjoined King as the "re-

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[2] The district court found, and the court of appeals agreed, that commercial paper is generally considered to be " 'an unsecured promissory note with a maturity term not exceeding 270 days, the proceeds of which are used for working capital.' " Appendix A, *infra*, pp. 11a-12a, n. 13.

sponsible" officer of King Resources and Coffey as an aider and abettor of the deceptive action. It did not reach the questions relating to the failure to disclose King Resources' financial condition and the proposed use of the loan proceeds.[3]

The court of appeals reversed, holding that the district court's theory of liability was erroneous as a matter of law (Appendix A, *infra*, p. 16a). The court determined that because the State of Ohio should have known that the National Credit Office's rating on commercial paper did not apply to two-year notes, the State of Ohio had not, in fact, been defrauded. The court concluded therefore that no violation of the antifraud provisions had occurred. (*Id.* at 16a.)

The court remanded the case against Coffey, for determination of the issues not reached by the district court, stating

> As to Appellant Coffey, who personally sent financial information to NCO [the National Credit Office], a potential finding under Rule 10b-5(2) is that he omitted material facts necessary to make the statements made to NCO not misleading. If the SEC can prove that the al-

[3] The district court previously had temporarily restrained the defendants, based on what it considered fraud regarding King Resources' use of its "prime" rating, but pending a trial had reserved judgment on the question of the company's financial condition and the use of the loan proceeds. Appendix B, *infra*, pp. 70a-71a. After the trial, the court adopted its earlier opinion as its findings of fact and conclusions of law. Appendix C, *infra*, pp. 95a-97a.

> leged omissions represent facts which were known or should have been known by Coffey while dealing with NCO, that they were necessary to make the information forwarded to NCO not misleading, and that Coffey knew or should have known that the omitted information was significant to NCO within the principles of SEC v. Capital Gains Bureau, 375 U.S. 180 * * * (1963), then Coffey may have violated Rule 10b-5(2). *In addition to these factors, however, it is essential that the SEC show that Coffey's inaction was in "wilful or reckless disregard for the truth."* [*Id.* at 17a-18a; footnote omitted, emphasis supplied.]

The court ordered that the action be dismissed against King, because he was not "a primary participant in the alleged deception on NCO or the State of Ohio * * *" (*id.* at 20a). It held that he could be liable as an aider and abettor of a securities law violation committed by another only if he had both a "general awareness that his role was part of an overall activity that * * * [was] improper" and that he "knowingly and substantially assisted the violation" (*id.* at 23a). It stated that negligence on his part would be insufficient (*id.* at 23a, n. 30).

REASONS FOR GRANTING THE WRIT

This case presents two important and recurring questions concerning the standards to be applied in injunctive suits brought by the Securities and Exchange Commission under the antifraud provisions of the federal securities laws. The first question,

about which the circuits are in sharp conflict, is whether in such an action the Commission must show that the defendant acted in "wilful or reckless disregard for the truth," rather than that he acted negligently. The second question is whether in such an action the Commission must establish that the party against whom the misrepresentations were directed was actually deceived by them.

By utilizing a "wilful or reckless" standard of care, appropriate—if at all—only to private damage actions brought under the antifraud provisions of the securities laws, and by requiring that the Commission show that the party against whom the misrepresentations were directed was actually deceived by them, the court of appeals has seriously handicapped the Commission's use of injunctions to protect the public against deception in the sale of securities. These restrictive standards are at odds with the broad remedial purpose of the antifraud provisions of the federal securities laws.[4]

1. In remanding the case for a determination whether Coffey had violated Rule 10b-5(2) by omitting material facts which would have apprised the

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[4] *See Affiliated Ute Citizens of Utah* v. *United States*, 406 U.S. 128, 151; *Securities and Exchange Commission* v. *Capital Gains Research Bureau*, 375 U.S. 180, 195. Cf., *e.g.*, *Superintendent of Insurance of New York* v. *Bankers Life & Cas. Co.*, 404 U.S. 6, 12; *Tcherepnin* v. *Knight*, 389 U.S. 332, 336; *Securities and Exchange Commission* v. *United Benefit Life Ins. Co.*, 387 U.S. 202; *Securities and Exchange Commission* v. *C. M. Joiner Leasing Corp.*, 320 U.S. 344, 350-351.

National Credit Office of King Resources' true financial condition, the court below held that, before an injunction may issue, the Commission must show that Coffey's inaction was in "wilful or reckless disregard for the truth" (Appendix A, *infra*, p. 18a). This holding conflicts with the decision of the Seventh Circuit in *Securities and Exchange Commission* v. *Dolnick*, No. 73-1752, decided August 16, 1974. There the court stated (slip op., p. 7) that the decision of the Sixth Circuit in the present case "is inconsistent with the law of this Circuit," and it quoted with approval the statement from *Securities and Exchange Commission* v. *Van Horn*, 371 F. 2d 181, 186 (C.A. 7):

> It is no defense to an action for injunction * * * that the admittedly false statements were uttered without knowledge or that there was no intention to omit the disclosure of material facts.

The decision below also apparently conflicts with decisions of the Eighth and Tenth Circuits, which have held that, even in private actions for damages under the antifraud provisions of the federal securities laws, only negligent conduct need be shown.[5]

Similarly, in holding that aiding and abetting requires knowing and substantial assistance in the violation (Appendix A, *infra*, p. 23a), the Sixth

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[5] See *City National Bank* v. *Vanderboom*, 422 F.2d 221, 229-230 (C.A. 8), certiorari denied, 399 U.S. 905; *Myzel* v. *Fields*, 386 F.2d 718, 734-735 (C.A. 8), certiorari denied, 390 U.S. 951; *Stevens* v. *Vowell*, 343 F.2d 374, 379-380 (C.A. 10).

Circuit espoused a standard in conflict with that of the Second Circuit, which has stated:

> In assessing liability as an aider and abettor, however, the district judge formulated a requisite standard of culpability—actual knowledge of the improper scheme plus an intent to further that scheme—which we find to be a sharp and unjustified departure from the negligence standard which we have repeatedly held to be sufficient in the context of enforcement proceedings seeking equitable or prophylactic relief. [*Securities and Exchange Commission* v. *Spectrum, Ltd.*, 489 F. 2d 535, 541.]

In holding that the Commission is required to show "wilful or reckless disregard for the truth," the court of appeals relied upon the reasoning of the Second Circuit in *Lanza* v. *Drexel & Co.*, 479 F. 2d 1277, 1306. In *Lanza*, which involved the question whether a director of a corporation aided and abetted a violation, the court concluded that the Commission's rule-making power under Section 10(b) of the Securities Exchange Act does not extend to imposing "liability for a mere negligent omission or misrepresentation" (*id.* at 1305). *Lanza*, however, involved a private suit for damages, which the court carefully distinguished from Commission suits seeking injunctive relief.[6] Other decisions in the Second Circuit have made it clear that in injunction actions the

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[6] 479 F.2d at 1304.

Commission need prove only that a defendant made or permitted representations to be made negligently.[7]

Whatever may be the basis for recovery in private actions for damages under the antifraud provisions of the federal securities acts, a less stringent test should apply to Commission suits seeking injunctive relief. Those suits are designed to protect the public rather than to obtain private redress for damages, and the relief they provide—the "mild prophylactic" of being enjoined from making materially misleading statements in connection with securities transactions, *Securities and Exchange Commission* v. *Capital Gains Research Bureau*, 375 U.S. 180, 193—imposes what is often a far less onerous burden upon the defendant than the award of damages. Moreover, in bringing such suits, the Commission is carrying out its statutory duty of protecting the public from securities frauds. The losses that innocent investors may suffer from such frauds are no less serious when the deception results from negligence than when it is done wilfully or recklessly.

2. The court's holding that for a fraudulent or deceptive scheme or practice to be established the victim must have been actually misled by the deception also presents an important question warranting

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[7] *Securities and Exchange Commission* v. *Spectrum, Ltd.*, *supra*, 489 F.2d at 541; *Securities and Exchange Commission* v. *Shapiro*, 494 F.2d 1301, 1308; *Securities and Exchange Commission* v. *Manor Nursing Centers, Inc.*, 458 F.2d 1082, 1096; *Securities and Exchange Commission* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 855, certiorari denied *sub nom. Kline* v. *Securities and Exchange Commission*, 394 U.S. 976.

review. In ruling that there were no violations of Section 17(a)(1) and (3) or Rule 10b-5(1) and (3) because the State of Ohio knew, or should have known, that the National Credit Office's rating on commercial paper did not apply to two-year notes, the court of appeals committed a similar error to that discussed in Point 1 above: it disregarded the broad remedial purpose of Commission enforcement action to protect the public from securities frauds.

The court of appeals made the right of the Commission to obtain injunctive relief turn upon the knowledge and sophistication of the particular purchaser. Although this may be a justifiable basis for determining, in a private suit for damages, whether a particular person has been defrauded,[8] it is totally inappropriate for determining whether, in a Commission injunction action, defendants have engaged in a scheme or practice which "* * * would operate as a fraud or deceit upon *any person*." Rule 10b-5(3), 17 C.F.R. 240.10b-5(3) (emphasis added). "The Commission's duty is to enforce the remedial and preventive terms of the statute in the public interest, and not merely to police those whose plain violations have already caused demonstrable loss or injury." *Berko* v. *Securities and Exchange Commission*, 316 F.2d 137, 143 (C.A. 2). Here, the Commission did not bring its injunctive action against the defendants for successfully defrauding the State of Ohio. It brought the action to enjoin them from again en-

[8] *Kohler* v. *Kohler*, 319 F.2d 634, 642 (C.A. 7); *Arber* v. *Essex Wire Corporation*, 490 F.2d 414, 420 (C.A. 6).

gaging in a course of conduct which would operate as a fraud in connection with securities transactions.

In a Commission injunction action, the knowledge or relative sophistication of the particular victim is irrelevant. Since the purpose of such a suit is generally to protect all members of the investing public, the gullible and uninformed as well as the sophisticated, the proper test is whether, viewed objectively, the misstatements or omissions would be likely to deceive any reasonable person. Otherwise, the Commission would be unable to protect the public against fraudulent practices likely to victimize them but which had been directed so far only against knowledgeable persons.

Although this Court has never considered this precise question, several lower courts have held that the Commission need not show, in administrative proceedings brought under the antifraud provisions of the securities acts, that the victims actually relied upon the misrepresentations.[9] Moreover, in *Affiliated Ute Citizens of Utah* v. *United States*, 406 U.S. 128, 153-154, this Court stated that proof of reliance is not a prerequisite to recovery for failure to disclose material facts in private damage actions under the antifraud provisions of the securities acts. "All that

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[9] *Hanly* v. *Securities and Exchange Commission*, 415 F.2d 589, 596 (C.A. 2); *Berko* v. *Securities and Exchange Commission*, 316 F.2d 137, 143 (C.A. 2); *N. Sims Organ & Co.* v. *Securities and Exchange Commission*, 293 F.2d 78, 80, n. 3 (C.A. 2), certiorari denied, 368 U.S. 968; *Hughes* v. *Securities and Exchange Commission*, 174 F.2d 969, 973-974 (C.A. D.C.).

is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision." *Ibid.* The same reasoning applies, even more forcefully, to injunction actions brought by the Commission.

This view is further supported by the broad, remedial purpose of the antifraud provisions of the securities acts. As this Court stated in *Securities and Exchange Commission* v. *Capital Gains Research Bureau, supra,* 375 U.S. at 186 (an injunctive action brought by the Commission under the Investment Advisors Act of 1940), these legislative enactments embrace a "fundamental purpose * * * to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry." This Court noted that Congress intended securities legislation enacted for the purpose of avoiding frauds to be construed "not technically and restrictively, but flexibly to effectuate its remedial purposes." It held, therefore, that no intent to defraud nor actual injury to the purchaser need be shown. *Id.* at 195. See also *Superintendent of Insurance of New York* v. *Bankers Life & Cas. Co.*, 404 U.S. 6, 12.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be granted.

Respectfully submitted.

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NOVEMBER 1974.

APPENDIX A

UNITED STATES COURT OF APPEALS
SIXTH CIRCUIT

Nos. 73-1396, 73-1397

SECURITIES AND EXCHANGE COMMISSION,
PLAINTIFF-APPELLEE

v.

WILLIAM V. COFFEY, DEFENDANT-APPELLANT
and
JOHN M. KING, DEFENDANT-APPELLANT

Argued Dec. 4, 1973
Decided March 28, 1974

Before CELEBREZZE, Circuit Judge, McALLISTER, Senior Circuit Judge, and WILSON,* District Judge.

CELEBREZZE, Circuit Judge.

This case presents novel issues for this Circuit regarding the Securities and Exchange Commission's ability to enjoin corporate officials personally for alleged corporate violations of the federal securities laws, specifically, § 17(a)(1) and (3) of the 1933 Securities Act and § 10(b) of the 1934 Securities Exchange Act, and Rule 10b-5(1) and (3) promulgated thereunder. Appellants are the board chair-

* The Honorable Frank W. Wilson, Chief Judge. United States District Court for the Eastern District of Tennessee, sitting by designation.

man (John King) and the financial vice-president (William Coffey) of King Resources Company.[1]

The relevant events began when Crofters, Inc., an Ohio "money-finder" formed in 1969, offered to arrange loans totaling $22,000,000 from the State of Ohio to four companies charged in the SEC complaint.[2]

One of Crofters' clients was King Resources Company, a Maine corporation with its headquarters in Colorado, engaged in oil well drilling in over a hundred countries. In early 1970 King Resources was short of cash and was seeking loans from various sources. In February, 1970, Ronald Howard, an independent money-finder and a defendant in the proceedings below, approached William Coffey (then King Resources' financial vice-president) with the proposal that King Resources seek funds from the State of Ohio. Howard told Coffey that long-term arrangements were possible but that it was a legal prerequisite to obtaining funds from the State that a company's commercial paper be rated "prime" by the National Credit Office, Inc. (NCO), a division of Dun & Bradstreet. Defendant Groban, a Crofters partner, contacted Coffey on February 19, 1970, and requested information that NCO would need to determine whether King Resources' commercial paper

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[1] These were Appellants' position at the time of the alleged violations.

[2] The loans of the four companies charged in the SEC's complaint were made through the Ohio Workmen's Compensation Fund and the Treasurer of Ohio. Both King Resources notes were purchased by the Treasurer.

merited a prime rating. Coffey sent these materials to Groban. Groban then asked NCO to rate King Resources for the commercial paper market. Rudolph Merker, NCO's vice-president for commercial paper, requested further information of Coffey, which was forthcoming and is not alleged to have been false. NCO promptly rated King Resources prime for the commercial paper market, on February 26, 1970. Groban notified Ohio's Deputy Treasurer of King Resources' prime NCO rating, and the State bought from King Resources a two-year $3,000,000 note on April 17, 1970 and a two-year $5,000,000 note on May 1, 1970.

King Resources soon thereafter collapsed financially, rendering Ohio's notes virtually worthless. On November 16, 1970, the SEC sued to enjoin further violations of the securities laws by 17 defendants, including King Resources and Appellants Coffey and King. The SEC alleged three different categories of securities law violations, only one of which applied to King Resources and Appellants. The Commission alleged that King Resources had sold its notes by misrepresenting its prime rating on commercial paper as proof that its two-year notes were also rated "prime." It further alleged that King Resources had failed to disclose material facts concerning its financial condition and the proposed use of the loan proceeds, omissions which tended to mislead NCO and the State of Ohio.[3]

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[3] The alleged omissions were that a large part of the funds to be obtained from the State was to be reloaned to other per-

On the basis of depositions and briefs, the District Court disposed of Appellee's motion for summary judgment on its petition for a preliminary injunction on August 10, 1972, by issuing a temporary restraining order against all 17 defendants. In a lengthy opinion, it held:

> [O]n the state of facts now before us, the Court concludes that the defendants' use of the word "prime", as defined by N.C.O. and the customs of the securities industry, in connection with notes of terms in excess of 270 days, constituted a violation of the standard promulgated in O.R.C. § 135.14. Further, that such use of the term "prime", in connection with non-commercial paper tended to operate as a "device, scheme, or artifice to defraud" within the meaning of Section 17(a)(1) and of Section 10(b) and Rule 10b-5(1) thereunder; and further constituted the engaging in a "transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser" within the meaning of Section 17(a)(3) and Section 10(b) and Rule 10b-5(3) thereunder. [citations omitted]. This conduct on the part of the defendants constitutes activity which should be enjoined by the equitable powers of this court.[4]

By restraining the 17 defendants, the District Court avoided the question whether the Defendants, particularly Groban, had omitted material informa-

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sons and that, at the time it issued its notes, King Resources was not meeting its obligations.

[4] District Court Opinion and Order, printed at 351 F.Supp. 236, 254 (S.D.Ohio 1972).

tion or had made false statements in representing the various companies' financial situations to Rudolph Merker of NCO:

> What is actionable in this case is the use of prime ratings, regardless of how they were obtained, for a purpose which would tend to confuse and mislead the purchasers. Holding as we do, it is unnecessary to consider whether there was a material omission within the meaning of section 17(a)(2) and Rule 10b-5(2). Defendants had the obligation to insure that the ultimate use of the prime ratings did not violate other provisions of Section 17(a) and 10(b). This obligation on their part might well have cautioned them to reveal that the terms of the various notes they intended to issue were in excess of 270 days and therefore not properly submitted for a prime rating. Deciding as we do, however, this determination is extraneous to the necessary grounds of our holdings.[5]

The District Court enjoined

> [T]he defendants who directly participated in obtaining prime ratings for Consolidated, Four Seasons and King Resources [who] knew or should have known that the notes ultimately issued were not properly described by the word "prime."[6]

These "directly participating" defendants included King Resources Company. Appellant King was en-

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[5] *Id.* at 255-256.

[6] *Id.* at 256.

joined as a "responsible officer" of King Resources.[7] Appellant Coffey was enjoined as an "aider and abettor" in the scheme.[8]

King Resources Company was nonetheless dismissed from the case because the District Court held that a prior Colorado injunction against the company was *res judicata* as to the present case. The SEC has not appealed that part of the ruling.

Soon after the temporary restraining order was issued, fourteen defendants submitted to consent decrees. Appellants persisted in their opposition to the SEC complaint and were afforded a hearing on consolidated motions for a preliminary and permanent injunction. They were allowed to present evidence concerning all factual matters, though the District Court refused to hear argument on the matters of law it had decided on August 10, 1972. On December 29, 1972, the District Court adopted the findings and conclusions of its August 10 Order in permanently enjoining Appellants from violations of § 17 (a)(1) and (3), § 10(b), and Rule 10b-5(1) and (3). It held that Appellants "engaged in or are legally responsible for acts, including those which culminated in obtaining for King Resources Company a rating of 'prime' from [NCO], which was substantially employed in connection with notes of term in excess of 270 days."[9] Appellants attack this final judgment and order.

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[7] *Id.*

[8] *Id.*

[9] District Court Order (S.D. Ohio, filed Dec. 29, 1972).

Before beginning a legal analysis of the District Court's actions, we confront a basic difference between the parties. Appellants argue that the District Court opinion tars them with the finding that they committed a fraud, thus jeopardizing their right to earn a livelihood. The SEC asserts in its Brief that injunctive relief is merely a "mild prophylactic," which requires "only that a defendant obey provisions of the law that he was already obliged to obey."

When the SEC brings an injunctive suit to protect the public interest in an open and honest securities market, courts will shape their relief flexibly to effectuate the purposes of the Act. SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 195, 84 S.Ct. 275, 11 L.Ed.2d 237 (1963); SEC v. Barraco, 438 F.2d 97, 98-99 (10th Cir. 1971). However, before an injunction will issue against a particular party in his personal capacity, it must be shown that he personally is about to commit, is committing, or has committed a securities law offense. The statutory authority of the SEC alone requires such a rule. *See* § 20(b) of the 1933 Act, 15 U.S.C. § 77t(b), and § 21(e) of the 1934 Act, 15 U.S.C. § 78u(e). In this case, all challenged activities have ended, so that the SEC has not based its request for relief on the assertion that defendants are "about to" commit a violation. Unless Appellants themselves violated the securities laws, there is consequently no basis to enjoin them for fear they will commit "further" violations. *See* SEC v. National Bankers Life Ins. Co., 324 F.Supp. 189, 197 (N.D.

Tex.1971), 334 F.Supp. 444 (D.C.), aff'd, 448 F.2d 652 (5th Cir. 1971).

We are disturbed by the SEC's tacit suggestion that a Court may personally enjoin a corporate official whenever his company or one of its agents has committed a securities law violation. An injunction is effectively drawn when it enjoins violators and their "agents, servants, employees and those persons in active concert or participation with them who receive actual notice of [an] Order." This is precisely the clause used by the District Court to enjoin all of Appellants' cohorts, in issuing its permanent injunction against Appellants.[10] Furthermore, it is a basic equity principle that "whenever an injunction, whatever its nature may be, is directed to a corporation, it also runs against the corporation's officers," in their corporate capacities. 10 W. Fletcher, Private Corporations § 4875 (1970 ed.). To name individuals personally and to find that they committed a violation they did not commit would be an intoler-

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[10] Final Judgment of Permanent Injunction (S.D.Ohio, filed Jan. 24, 1973). We note that the SEC sued Appellant King in his personal capacity in its Colorado suit against King Resources Co. The District Court of Colorado issued an injunction against "King Resources Company, and its officers, directors, agents, employees, assigns and attorneys, and those persons in active concert or participation with them." This wording effectively enjoins King in his corporate capacity from participating in violations the Court found had been committed by the Company, without singling him out as having committed a violation. SEC v. King Resources Co., Civil No. C-2858 (D.Colo., filed Feb. 9, 1971). See Rule 65(d), Fed.Rules Civ.Proc.

able abuse of the judicial process. In practical consequence, it would damage the reputations of persons without reason to believe that they personally had violated the securities laws. *Cf.* SEC v. Frank, 388 F.2d 486, 489 (2d Cir. 1968). Such an arbitrary procedure would also deny named defendants basic constitutional rights in subsequent proceedings, since a personal injunction would be enforceable through contempt proceedings, even if a future violation were alleged that was based on activity wholly apart from the individuals' corporate relationship.[11] In a contempt proceeding, of course, the defendants would be deprived of the right to defend their actions before a jury. Unless an individual is about to commit, is committing, or has committed a securities law violation, he may not be enjoined in his personal capacity by the SEC. *Cf.* SEC v. International Camra-Corder Corp., CCH Sec. Law Rptr. para. 91,666 (S.D.N.Y.1966).

The District Court found that Appellants had violated section 17(a)(1) and (3) of the 1933 Securities Act and section 10(b), specifically Rule 10b-5 (1) and (3), of the 1934 Securities Exchange Act.[12]

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[11] The significance of naming an officer or director personally is that "otherwise he si bound only as long as he remains an officer or director, whereas if he is named he is personally is that "otherwise he is bound only as long as he re-Regulation 4113 (1969, supp. to 2d ed.).

[12] Section 17(a) of the 1933 Act, 15 U.S.C. § 77q, provides:

(a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of

In basic terms, these provisions make it illegal to employ a fraudulent scheme or to engage in a deceptive practice in connection with securities sales or purchases. The District Court did not make findings concerning alleged liability under section 17(a)(2) or Rule 10b-5(2), which prohibit false statements

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transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

Rule 10b-5, 17 C.F.R. 240.106-5, provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

(1) to employ any device, scheme, or artifice to defraud.

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
were made, not misleading, or

(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

and omissions of material fact which would tend to mislead securities purchasers or sellers.

Were it the case that Appellants knowingly used King Resources' "price" rating on commercial paper as certification of prime quality for their two-year notes (which do not qualify as "commercial paper"), in a misleading manner and without a justifiable excuse, we would have no hesitation in affirming the District Court's conclusions. We must reverse the holding below, however, because no fraudulent or deceptive scheme or practice has been established. We note that in reviewing this case, decided as it was primarily on the basis of depositions and briefs, we are in as good a position as the District Court to review the pleadings, affidavits, and depositions, and to arrive at conclusions of mixed law and fact. Dopp v. Franklin National Bank, 461 F.2d 873, 879 (2d Cir. 1972).

The basic factor which precludes a finding of liability under section 17(a)(1) and (3) and Rule 10b-5(1) and (3) is that King Resources' use, as such, of its prime rating on commercial paper could not have been fraudulent or deceptive. Ohio law required as a precondition for borrowing funds that King Resources show a "prime" rating from NCO on its commercial paper, even though a loan being sought from the State of Ohio would extend beyond 270 days, thus taking it outside the category of commercial paper.[13]

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[13] We accept the District Court's conclusion that "commercial paper" is "an unsecured promissory note with a

Section 135.14, Ohio Rev.Code, limits the entities in which the State Treasurer may invest "interim moneys" of the State to five categories, and limits the term of any obligation to two years. King Resources was eligible to borrow funds only under the following limitation: [14]

> "In addition to the investments specified in subparagraphs (A), (B), (C), and (D) of this section, the treasurer of state may invest interim moneys of the state in commercial paper notes issued by any corporation for profit which is incorporated under the laws of the United States, a state, or the District of Columbia, which such notes are rated prime by the National Credit Office, Inc., New York, or its successor, provided that the aggregate total amount of interim moneys invested in commercial paper at any time shall not exceed fifty million dollars."

This section, taken literally, would bar investments of Ohio interim moneys in any corporate notes, out-

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maturity term not exceeding 270 days, the proceeds of which are used for working capital," a definition used by NCO and accepted by Appellants and the securities industry generally. 351 F.Supp. at 252. *See* Handal. "The Commercial Paper Market and the Securities Acts," 39 U.Chi.L.Rev. 362, 363-64 (1972).

[14] There has been no allegation by any party that the investment was sanctioned by other provisions of Ohio law, though section 135.14 may not be an exclusive authorization, since it only applies to the investment of "interim" moneys. Thus, we cannot reach the conclusion of the District Court which considered a similar loan, to a co-defendant in the instant case, to be outside the purview of § 135.14. *See* In re Four Seasons Nursing Centers of America, Inc., 329 F.Supp. 647, 651 (W.D.Okl. 1971).

side those specified in paragraphs (A), (B), (C), and (D), which exceed 270 days in duration, since NCO rates companies *only* on their commercial paper, that is, notes of less than a 270-day duration.[15]

Yet, King Resources offered and the State Treasurer bought notes of *two years'* duration. If we assume that the investment was illegal under Ohio law, the error involved was by the Treasurer of the State, not a fraud practiced by King Resources upon the Treasurer. Under such a view of section 135.14, Ohio Rev. Code, both the Treasurer and King Resources knew exactly the terms of the sale,[16] neither being excused from its ignorance of the fact that a two-year note would be improper under Ohio law. We need only conclude that it is not fraudulent to offer a two-year note so long as it is represented as such to determine that King Resources committed no fraud upon the Treasurer if the Treasurer was not authorized to purchase a two-year note.[17]

If, however, we assume that section 135.14 authorizes the purchase of two-year notes from corporations

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[15] See n. 13, *supra.*

[16] This is the apparent basis of the District Court's holding in In re Four Seasons Nursing Centers of America, Inc., 329 F.Supp. at 651-52.

[17] The Treasurer of the State of Ohio has an obligation to determine whether its investments accord with state law and, specifically, whether an item of commercial paper offered for sale has been rated prime by NCO. *See* Ohio Op. Att'y Gen. No. 70-067 (1970). We cannot describe the Treasurer's failure to fulfill this elementary duty as a fraud practiced upon it by a securities offeror.

such as King Resources,[18] then we must make sense of the requirement that the notes be rated "prime" by NCO. More than a month after the Treasurer bought the King Resources notes, the Ohio Attorney General advised the Treasurer that a two-year note would be a proper investment if it were rated "prime commercial paper" by NCO.[19]

The difficulty which this Opinion poses stems from a latent defect in section 135.14, which authorizes investments only in commercial paper rated "prime" by NCO. In fact, NCO does not rate notes. It only rates companies. If a company can show that it meets the criteria for a "prime" rating on commercial paper it might issue,[20] NCO rates the company "prime" for the commercial paper market. Only by implication may a particular note be considered to have a "prime" rating, since NCO does not rate individual issues of notes.

Thus, a company seeking funds from the State of Ohio is forced to proceed by submitting to the State a proposal of a note not exceeding two years in

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[18] Such an interpretation would require a finding that the Ohio legislature intended "commercial paper" to encompass notes of a duration more than twice that of the currently established definition, or that it intended to authorize NCO to determine the legal definition of commercial paper under Ohio law. Ohio Attorney General Opinion No. 70-067, *supra*, n. 17, adopts the latter view.

[19] *Id.*

[20] The criteria include such factors as liquidity position, bank credit line, net worth, and track record. *See* Handal, *supra*, n. 13, at 371-73.

duration, coupled with a showing that the company itself is rated "prime" on its commercial paper by NCO. This is the only manner in which a company can establish its eligibility for an Ohio loan under § 135.14, Ohio Rev. Code, since NCO only rates companies on their commercial paper (notes of less than 270-day duration). It does not provide ratings which are necessarily valid in evaluating the quality of two-year notes.[21]

Under these circumstances, we cannot characterize a company's use of NCO's "prime" rating on its commercial paper in seeking to sell two-year notes to the State of Ohio as a fraudulent scheme or a deceptive practice. King Resources' use of its "prime" rating was mandated by state law as a pre-condition to selling its notes to the State, so that the State cannot, as a matter of law, have been defrauded by such use. Fraud or deceit presupposes the superior knowledge of one party over another. *See* Myzel v. Fields, 386 F.2d 718, 739 (8th Cir.), cert. denied, 390 U.S. 951, 88 S.Ct. 1043, 19 L.Ed.2d 1143 (1968). The State was not in the position of an innocent purchaser, misled by an insider's use of a prime rating on short-term paper to justify the quality of its longer term notes, since the State itself required pre-

[21] A "prime" rating on commercial paper means that the rated company will most assuredly be able to pay off the short-term note through the proceeds of a product cycle which is financed by the short-term loan. A rating on a two-year loan would depend on quite different factors, such as the long-term viability of the enterprise and longer-range forecasts of business conditions.

cisely the showing it received. A section 17(a)(1) and (3) or Rule 10b-5(1) and (3) violation depends on one party's taking unfair advantage of another party through a deceptive practice or fraudulent scheme. There is no duty to disclose information to one who reasonably should already be aware of it. Kohler v. Kohler Co., 319 F.2d 634, 642 (7th Cir. 1963); Arber v. Essex Wire Corp., 490 F.2d 414 at 420 (6th Cir. 1974). Since both King Resources and the State are held to the knowledge that NCO's rating on commercial paper did not apply to two-year notes, it follows that no violation of these sections of the securities laws could have occurred.

The District Court's finding of Appellants' liability under section 17(a)(1) and (3) and section 10(b), specifically Rule 10b-5(1) and (3), therefore, is erroneous as a matter of law and must be reversed.

The District Court made no findings as to liability under section 17(a)(2) and Rule 10b-5(2), though much evidence was presented on this point. The SEC presented its entire case below and makes no claim that other evidence would be presented should we remand for findings under section 17(a)(2) and Rule 10b-5(2). On the record in this case, we conclude that a remand would be inappropriate in the case of John King, though the SEC should have the chance to show that William Coffey is liable under these provisions.

Section 17(a)(2) and Rule 10b-5(2) are directed against false statements and omissions of material fact in connection with securities sales and purchases.

In the instant case King Resources' agents may have omitted material facts both in obtaining a prime rating from NCO and in negotiating with the State of Ohio. The alleged omission in obtaining NCO's prime rating are that King Resources was planning to sell two-year (non-commercial) notes to Ohio, that the company was not meeting creditor obligations, and that it was planning to impair its ability to repay short-term loans by reloaning part of its borrowed funds. The alleged omissions in negotiating with the State of Ohio are that King Resources' "prime" NCO rating did not apply to the two-year notes, that King Resources was not meeting obligations maturing at the time of sale, and that King Resources planned to reloan a substantial part of the proceeds of the Ohio borrowings.

As to Appellant Coffey, who personally sent financial information to NCO, a potential finding under Rule 10b-5(2) is that he omitted material facts necessary to make the statements made to NCO not misleading.[22] If the SEC can prove that the alleged omissions represent facts which were known or should have been known by Coffey while dealing with NCO, that they were necessary to make the information forwarded to NCO not misleading, and

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[22] Since NCO was not buying a security, liability cannot rest under section 17(a). Rule 10b-5, however, posits liability for deceptive practies "in connection with" a security sale. Since the NCO prime rating was an essential ingredient of the Ohio sale, there is a direct connection between obtaining the prime rating from NCO and the Ohio loan, and Rule 10b-5 comes into play.

that Coffey knew or should have known that the omitted information was significant to NCO within the principles of SEC v. Capital Gains Bureau, 375 U.S. 180, 84 S.Ct. 275, 11 L.Ed.2d 237 (1963), then Coffey may have violated Rule 10b-5(2). In addition to these factors, however, it is essential that the SEC show that Coffey's inaction was in "wilful or reckless disregard for the truth." The Second Circuit, sitting *en banc*, recently established this standard in regard to private damage actions in similar situations. Lanza v. Drexel & Co., 479 F.2d 1277, 1306 (2d Cir. 1973). *Cf.* Mader v. Armel, 461 F.2d 1123 (6th Cir.), cert. denied, 409 U.S. 1023, 93 S.Ct. 465, 34 L.Ed.2d 315 (1972). Although *Lanza* involved private plaintiffs, and the standards of culpability may be lower in SEC injunctive suits than in private damage actions, SEC v. Capital Gains Bureau, *supra*, the reasoning of the Second Circuit in *Lanza* fully supports our conclusion that the SEC's proof in an injunctive suit must meet the standard of showing "wilful or reckless disregard for the truth."

Although the allegations in this case may make Coffey a direct participant in a Rule 10b-5(2) violation in his dealings with NCO, a different question arises as to Appellant King's relationship to the Ohio and NCO contacts and as to Appellant Coffey's relationship to the Ohio negotiations. In these three instances Appellants had no direct contact with the allegedly misled parties. The record shows that as Chairman of the Board, King attended both Execu-

tive Committee meetings where the Ohio loans were authorized. Between these meetings King met with Defendants Groban and Griffiths (of Crofters, Inc.) to discuss additional funds, with no evidence of discussion of Groban's representations to NCO or the State of Ohio. Coffey's involvements in the Ohio loan negotiations were his participation in the meetings which approved the two Ohio loans, his signature on the notes, and his general oversight of King Resources' financial affairs as its financial vice-president.

In considering whether King's alleged involvement in either NCO or Ohio dealings (and Coffey's as to the Ohio negotiations) violated section 17(a)(2) or Rule 10b-5(2), we start by noting the three categories of liability for which a person may be enjoined under the securities laws.[23] First, a person may have directly participated in the deceit, endowing him or her with primary liability for the violation. Second, he or she may have knowingly assisted the commission of a violation by another party, making him or her secondarily liable for the violation. Third, a party may have been a "controlling person" of another who is liable for a securities law violation, so as to be liable under section 20 of the Securities Exchange Act of 1934.

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[23] *See generally* Ruder, "Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification, and Contribution," 120 U.Pa.L.Rev. 597 (1972); A. Bromberg, Securities Law Fraud, § 8.5 (515-583), 208.5-.46 (1971).

We cannot find any evidence to support the contention that King was a primary participant in the alleged deception on NCO or the State of Ohio or that Coffey was a direct participant in the Ohio negotiations. Neither King nor Coffey had any contact with the officials negotiating for the State of Ohio, and King had no contact with NCO officials. Since in this case liability under section 17(a)(2) and Rule 10b-5(2) depends on proof of a deceptive omission in the context of deliberations with NCO or Ohio officials, only those individuals who had an affirmative obligation to reveal what was allegedly omitted can be held as primary participants in the alleged deception. A duty to disclose naturally devolved on those who had direct contacts with "the other side." [24] In the case of King and Coffey as to the Ohio officials and King as to NCO, we would have to imply a duty to contact the allegedly deceived officials and to disclose the allegedly omitted facts.

Here the duty which we would have to posit to find primary liability is the duty of a corporate board chairman and financial vice-president carefully to

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[24] Direct contacts may take many forms. An accountant or lawyer, for instance, who prepares a dishonest statement is a primary participant in a violation even though someone else many conduct the personal negotiations with a securities purchaser. *See* H. L. Green Co. v. Childree, 185 F.Supp. 95 (S.D.NY. 1960); Fischer v. Kletz, 266 F.Supp. 180, 189-194 (S.D.N.Y. 1967); SEC v. Spectrum, Ltd., 489 F.2d 535 (2d Cir. 1973); Hooper v. Mountain States Securities Corp., 282 F.2d 195 (5th Cir. 1960), cert. denied, 365 U.S. 814, 81 S.Ct. 695, 5 L.Ed.2d 693 (1961).

supervise the activities of a money-finder in its negotiations with a State Treasurer's Office, and in the NCO case, a corporate board chairman's duty to monitor his financial vice-president's dealings with a credit-rating agency. Imposing such a duty would effectively make corporate officials primarily liable for any securities law violation by a subordinate. It would disrupt corporate systems of delegation of authority and accountability and would, *sub silentio*, repeal the protections contained in the "controlling persons" provision, section 20 of the 1934 Act. We refuse to impose such a duty.[25] Our refusal is in accordance with other decisions which have declined to impose duties on persons not in a special relationship with a buyer or seller of securities. SEC v. Great American Industries, Inc., 407 F.2d 453, 460 (2d Cir. 1968) (*en banc*); Lanza v. Drexel & Co., 479 F.2d 1277 (2d Cir. 1973) (*en banc*); Mader v. Armel, 461 F.2d 1123 (6th Cir. 1972).

The second category under which Appellants might be held is that of secondary liability. This is the category in which the District Court seems to have placed Appellants, since it held King liable as a "responsible officer" of King Resources and described Coffey as an "aider and abettor." [26]

Secondary liability is imposed under concepts bor-

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[25] Thus, we need not reach the thorny general question whether some form of *scienter* must be shown as a prerequisite to imposing liability or whether mere negligence or misrepresentation suffices to establish a violation.

[26] *See* nn. 8, 9, *supra*.

rowed from the common and the criminal law—"aiding and abetting" and conspiracy.[27] We are aware of no other standard of secondary liability in securities law, aside from the "controlling persons" provision of section 20 of the 1934 Act (treated herein as a separate category).

A detailed discussion of conspiracy is unnecessary here, since no evidence of conspiracy existed. An essential element of conspiracy is an agreement to accomplish a wrongful purpose.[28] Here the wrongful purpose would have been to omit material facts in dealing with NCO and Ohio officials. Casting Appellants' inaction into a conspiracy with Crofters' personnel to accomplish this purpose would stretch the usefulness of the conspiracy concept far beyond its proper elasticity.

Appellants' actions are better analyzed under the aiding and abetting rationale. Aiding and abetting has been defined by courts considering securities

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[27] *See generally* Ruder, *supra*, n. 23, at 620-46. It is also imposed upon corporations whose agents commit violations, under the traditional concept of *respondent superior. See, e.g.*, Johns Hopkins Univ. v. Hutton, 297 F.Supp. 1165 (D.Md. 1968), aff'd in part, rev'd in part and remanded, 422 F.2d 1124 (4th Cir. 1970).

[28] Dasho v. Susquehanna Corp., 380 F.2d 262, 264, 267, n. 2 (7th Cir.), cert. denied sub nom. Bard v. Dasho, 389 U.S. 977, 88 S.Ct. 480, 19 L.Ed.2d 470 (1967).
See Ruder, *supra*, n. 23, at 627, 631, 639. Prof. Bromberg describes a conspiracy in a securities law context as entailing "actions in different areas of responsibility of relatively equal importance." A. Bromberg, Securities Law: Fraud, § 8.5(515), 208.6 (1971).

law cases with reference to both the Restatement of Tort, § 876 (1939), and the criminal law, 18 U.S.C. § 2 (1969).[29] Without meaning to set forth an inflexible definition of aiding and abetting, we find that a person may be held as an aider and abettor only if some other party has committed a securities law violation, if the accused party had general awareness that his role was part of an overall activity that is improper, and if the accused aider-abettor knowingly and substantially assisted the violation.[30]

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[29] *See* Brennan v. Midwestern United Life Ins. Co., 259 F. Supp. 673, 680 (N.D.Ind. 1966), 286 F.Supp. 702 (N.D.Ind. 1968), aff'd, 417 F.2d 147 (7th Cir. 1969): A. Bromberg, Securities Law: Fraud, § 8.5(530), 208.20 (1971).

[30] *See* SEC v. Timetrust, Inc., 142 F.2d 744, 746 (9th Cir. 1944); Fischer v. Kletz, 266 F.Supp. 180, 197 (S.D.N.Y. 1967); *Brennan, supra*; Iroquois Industries, Inc. v. Syracuse China Corp., 417 F.2d 963, 970 (2d Cir. 1969), cert. denied, 399 U.S. 909, 90 S.Ct. 2199, 26 L.Ed.2d 561 (1970); Nye & Nissen v. United States, 336 U.S. 613, 619, 69 S.Ct. 766, 93 L.Ed. 919 (1949); Ruder, *supra*, n. 23, at 626-38, 641-44; A. Bromberg, Securities Law: Fraud § 8.5(582), 208.45 (1971).

We view the Second Circuit's decision in SEC v. Spectrum Ltd., 489 F.2d 535 (2d Cir. 1973), as correct on its facts. There a lawyer was aware that his misleading opinion letter could be used to sell unregistered securities and failed to take timely steps to prevent such use. We do not believe that this application of a negligence standard to that situation compels us to apply a negligence standard in the very different case we confront. Here, there must be some showing that Appellants were aware of the Crofters' personnel's alleged misrepresentations. We note further that the attorney in *Spectrum, Ltd.* had committed three prior securities law violations, so that his argument of innocent knowledge was subject to doubt.

In this regard, we note that Coffey testified that he discussed the terms of the Ohio loan with Groban of Crofters, Inc. Should the District Court find that through this contact Coffey became aware that Crofters' personnel were misleading the State of Ohio, his knowledge that a violation was occurring would be established and his failure to take remedial action would be a form of aiding and abetting.

We find no evidence, however, that King knew that the personnel of Crofters, who conducted the actual negotiations with the State of Ohio, were misleading the state as to the terms of the loan, the meaning of the NCO prime rating, or King Resources' financial condition. Nor do we find any evidence that King knowingly assisted any deception which Crofters' personnel may have perpetrated on State officials. Inaction may be a form of assistance in certain cases, but only where it is shown that the silence of the accused aider and abettor was consciously intended to aid the securities law violation.[31] SEC v. Timerust, Inc., 142 F.2d 744, 745 (9th Cir. 1944); Brennan v. Midwestern United Life Ins. Co., 417 F.2d 147, 154-155 (7th Cir. 1969) cert. denied, 397 U.S. 989, 90 S.Ct. 1122, 25 L.Ed.2d 397 (1970); Fischer v. Kletz, 266 F.Supp. 180, 195 (S.D.N.Y. 1967) (inaction claim dismissed as to financial statements accountants did not prepare); Wessel v. Buhler, 437 F.2d 279, 283 (9th Cir. 1971); SEC v.

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[31] *See* Ruder, *supra*, n. 23, at 641-44, note, "Accountants' Liability for False and Misleading Financial Statements," 67 Colum.L.Rev. 1437, 1447-50 (1967).

National Bankers Life Ins. Co., 324 F.Supp. 189, 195 (N.D. Tex.), 334 F.Supp. 444 (D.C.), aff'd, 448 F.2d 652 (5th Cir. 1971).

Normally, intent to commit a securities law violation does not require independent proof. Texas Continental Life Ins. Co. v. Dunne, 307 F.2d 242, 249 (6th Cir. 1962); SEC v. Capital Gains Bureau, 375 U.S. 180, 193, 84 S.Ct. 275, 11 L.Ed. 2d 237 (1963). Knowledge that a securities law violation would be furthered by one's silence or inaction, however, must be proven by reliable and probative evidence, Pettit v. American Stock Exchange, 217 F.Supp. 21, 28 (S.D.N.Y.1963); SEC v. National Bankers Life Ins. Co., 324 F.Supp. 189, 195 (N.D.Tex.), aff'd per curiam, 448 F.2d 652 (5th Cir. 1971), final judgment entered, 334 F.Supp. 444, 456 (N.D.Tex.1971), aff'd, 477 F.2d 920 (5th Cir. 1973), though the evidence may be circumstantial as well as "direct." SEC v. National Bankers Life Ins. Co., *supra*. Were such proof not required, a person who is not primarily liable for a violation could yet be held personally liable for the violation, even though he or she was unaware of the need to disclose information withheld by those primarily liable. The result would be to impose liability for an innocent omission, for non-culpable inaction.[32] This would stretch the application of Rule 10b-5 beyond

[32] In Fry v. Schumaker, 83 F.Supp. 476 (E.D.Pa. 1947), for example, the Court held that a broker could be held liable for providing assistance to others only if he "knew" that doing so served essentially the fraudulent scheme.

its statutory limits, since section 10b of the 1934 Act does not impose liability for innocent acts but only for acts of fraud or deceit.[33]

The same analysis leads to the conclusion that King could not be considered an aider and abettor to an alleged Rule 10b-5(2) violation committed in King Resources' dealings with NCO. There is no evidence that King was personally aware of any omissions of material fact by Crofters' personnel and Coffey in their dealings with NCO, and there is no indication that he had reason to suspect that a misrepresentation might be made. As we have pointed out above, he need not have doubted the propriety of seeking a "prime" rating, since King Resources needed it to place notes with the State of Ohio and

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[33] Section 10(b) of the Exchange Act of 1934 provides as follows:

It shall be unlawful for any person, direcly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

For a discussion of Rule 10b-5's non-application to nonculpable conduct, *see* Note, "Corporations—Rule 10b-5—Nonparticipating Corporate Director Owes No Duty to Insure that all Material, Adverse Information is Conveyed to Prospective Purchasers," 5 St. Mary's L.J. 382, 387 (1967).

to sell other commercial paper being prepared for sale in May 1970.[34]

The third category of possible liability is contained in section 20 of the 1934 Securities Exchange Act. Section 20 provides:

> (a) Every person who, directly or indirectly, controls any person liable under any provision of this title or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.
>
> (b) It shall be unlawful for any person, directly or indirectly, to do any act or thing which it would be unlawful for such person to do under the provisions of this title or any rule or regulation thereunder through or by means of any other person. 15 U.S.C. § 78t.

The District Court did not specifically anchor its finding of liability on this section. Yet, its reference to King as the "responsible officer" of King Resources suggests that this section might have been the source of its holding.

The Commission asserts that King was a controlling person within section 20(a) of the 1934 Act and that it may be inferred from the District Court's holding that he failed to establish a "good faith"

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[34] King Resources had scheduled an issue of commercial paper through an established underwriter for May 1970.

defense, since the District Court ruled against King.

We cannot assume that the District Court used Section 20(a) to hold King liable. Whether a person "controls" another under section 20(a) is a complex factual question. Klapmeier v. Telecheck International, Inc., 315 F.Supp. 1360 (D.Minn.1970). *But cf.* Myzel v. Fields, 386 F.2d 718, 738 (8th Cir. 1967). There is no indication that the District Court made a factual finding to that effect or gave notice to King that he should establish a defense against such a finding.

Even had proper findings been made, however, we hold that section 20(a) of the 1934 Act may not be relied upon by the SEC in an injunctive enforcement action. Section 20(b) of the 1934 Act provides for the *unlawful* actions of controlling persons, and the SEC may only seek injunctions against unlawful actions. *See* section 20(b) of the 1933 Act, 15 U.S.C. § 77t(b); section 21(e) of the 1934 Act, 15 U.S.C. § 78u(e). Section 20(a) of the 1934 Act makes a controlling person liable "to any person to whom such controlled person is liable." As a matter of legislative interpretation, we hold that the SEC is not a person under section 20(a), since section 20(a) was meant to specify the liability of controlling persons to private persons suing to vindicate their interests. Section 20(b) sets forth the standard of lawfulness to which a controlling person must conform, on penalty of liability in injunction to the SEC or criminal prosecution.

Under section 20(b), there must be shown to have been knowing use of a controlled person by a controlling person before a controlling person comes within its ambit. Without such a restriction, every link in a chain of command would be personally criminally and civilly liable for the violations of inferior corporate agents. This was not the congressional intent in enacting section 20(b). As we concluded above, King has not been shown to have had any knowledge of Crofters' personnel's dealings with either the State of Ohio or NCO, nor can we find a scintilla of proof that he "used," directly or indirectly, Crofters' personnel to carry out a violation.

We conclude that on the record as a whole King could not be held liable as a participant, as a secondary party, or as a controlling person for any possible section 17(a)(2) or Rule 10b-5(2) violations of King Resources' agents. Thus, the case must be dismissed as to him.

As to Coffey, we find the allegations of his role in obtaining a "prime" rating from NCO sufficient to warrant a hearing on Rule 10b-5(2) liability as a primary participant in omitting material facts in a misleading way. Further, we find that Coffey may be held liable as an aider and abettor under Rule 10b-5(2) if it should be proved that he was aware that actionable fraud was being perpetrated on State of Ohio officials and that he failed to take available remedial action.

Reversed and remanded for proceedings consistent with this Opinion.

APPENDIX B

UNITED STATES DISTRICT COURT
S. D. Ohio, E. D.

Civ. A. No. 70-351

SECURITIES AND EXCHANGE COMMISSION, PLAINTIFF

v.

CROFTERS, INC., ET AL., DEFENDANTS

Aug. 10, 1972

OPINION AND ORDER

CARL B. RUBIN, District Judge.

This matter comes before the Court on the motion for a preliminary injunction as against all defendants filed by plaintiff Securities and Exchange Commission (S.E.C.); the motions for summary judgment filed by defendants Crofters, Inc., Deegee Company, Regency Acceptance Corporation, Donahue, Griffith, Groban, Consolidated Oil & Gas, Inc., Trueblood, Kerr, Clark, Coffey and King Resources Company; and cross motions for summary judgment by S.E.C. against Consolidated, Trueblood, Kerr and Clark.[1] Voluminous briefs and depositions have been

[1] King Resources' motion for summary judgment rests on grounds which are disparate from those raised by the other moving defendants and will therefore be treated separately below. The plaintiff's motion for default judgment against defendant Howard was rendered insubstantial by his answer

submitted to and carefully considered by the Court. For the purposes of this Order the details of this matter, as colligated by the Court at this point of the proceedings, are as set forth below.

I

Dramatis Personae

Defendants Crofters, Inc., is a corporation organized and incorporated under the laws of Ohio and has its principal place of business in Columbus, Ohio. Its principal shareholders and officers are defendants Donahue, Griffith and Groban all of whom reside in the Southern District of Ohio. Defendant Deegee Company (hereinafter Deegee) is a partnership composed of these same three individuals and Regency Acceptance Company (hereinafter Regency Acceptance) is a sole proprietorship owned by defendant Groban. Both Deegee and Regency Acceptance have their principal place of business in Columbus, Ohio.

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of July 20, 1972 and the plaintiff has expressed to the Court its intention to withdraw said motion. It will therefore not be considered. Defendants Colorado Corporation, LCM Corporation, Regency Income Corporation, King and Lore have not filed any motions before the Court. They are involved in the present matter only to the extent that the S.E.C.'s motion for preliminary injunction seeks injunctive relief as to them as well. The issues raised in Clark's motion to dismiss dated December 10, 1970 are reiterated in a more complete fashion in his instant motion for summary judgment. Pursuant to Rule 12(b). Fed.R.Civ.P. the Court will deem the former motion merged into the latter and will treat them collectively.

Defendant Consolidated Oil & Gas, Inc., (hereinafter Consolidated) is a corporation organized and incorporated under the laws of the State of Colorado, and has its principal place of business in Denver. Its principal business functions are the exploration and sale of oil and gas and the development and drilling of oil and gas wells. Defendant Trueblood is chairman of Consolidated's board of directors.

Defendant King Resources Company (hereinafter King Resources) is a corporation organized and incorporated under the laws of the State of Maine, having its principal place of business in Denver, Colorado. During material times herein and at least until August, 1970, defendant John King was chairman of King Resources' board of directors and defendant Coffey was its executive vice-president. This company is now in reorganization proceedings under Chapter X of the Bankruptcy Act, 11 U.S.C.A. § 501 et seq. before the United States District Court for the District of Colorado. Defendant Colorado Corporation is a Colorado concern with its principal place of business in Denver, Colorado. It has been controlled by defendant King and his immediate family. Defendant Regency Income Corporation, (hereinafter Regency Income) a Colorado corporation having its principal place of business in Denver, Colorado, is a wholly owned subsidiary of Regency Management Corporation which, in turn, is a wholly owned subsidiary of defendant Colorado Corporation. Defendant Kerr was the president of both Regency

Income Corporation and Regency Management Corporation during times material herein.[2]

Defendant Four Seasons Nursing Centers of America, Inc., (hereinafter Four Seasons) is a Delaware corporation having its principal place of business in Oklahoma City, Oklahoma. Its principal business function is the development and operation of health care centers. Four Seasons is currently in reorganization proceedings under Chapter X of the Bankruptcy Act, 11 U.S.C. § 501 et seq., before the United States District Court for the Western District of Oklahoma. Defendant Clark was the president of Four Seasons during times material to the complaint in this suit.

Defendant LCM Corporation is an Ohio corporation with its principal place of business in Columbus, Ohio. Defendant Lore is chairman of LCM's board of directors and was, until January 1970, investment officer and investment consultant to the School Employees Retirement System of Ohio (hereinafter SERS). Defendant Howard is an independent money-finder and works out of Los Angeles, California. By terms of a consent decree Howard and his company, R. R. Howard & Company, Inc., have been prohibited from registering as broker-dealers under Section 15(b) of the Securities and Exchange Act of 1934. See Securities Exchange Act Release No. 8009, December 20, 1966.

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[2] Regency Management Corporation is not a defendant in the instant action. Defendant Kerr is therefore before the Court only in his capacity as president of Regency Income.

The plaintiff Commission is a federal regulatory agency charged with the enforcement of federal securities law. It has brought this action under Section 20(b) of the Securities Act of 1933, 15 U.S.C. § 77t(b) and Section 21(e) of the Exchange Act of 1934, 15 U.S.C. § 78u(e).[3] The jurisdiction of this Court is properly invoked pursuant to Section 22(a) of the 1933 Act, 15 U.S.C. § 77v(a) and Section 27 of the 1934 Act, 15 U.S.C. § 78aa. SEC seeks to enjoin pursuant to its five count complaint, allegedly fraudulent and deceptive practices committed by the nineteen corporate and individual defendants.

II

The Complaint

Count I of the complaint, directed against all of the defendants except LCM Corporation and Lore, alleges violations of Section 17(a) of the Securities

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[3] These statutory provisions are nearly identical and both confer broad equitable powers upon this Court. Section 21(e) of the 1934 Act, for example, provides in material part as follows:

> Whenever it shall appear to the Commission that any person is engaged or about to engage in any acts or practices which constitute or will constitute a violation of the provisions of this chapter, or of any rule or regulation thereunder, it may in its discretion bring an action in the proper district court of the United States or the United States courts of any Territory or other place subject to the jurisdiction of the United States, to enjoin such acts or practices, and upon a proper showing a permanent or temporary injunction or restraining order shall be granted without bond. 15 U.S.C. § 78u(e).

Act of 1933, 15 U.S.C. § 77q(a), in the offer and sale of securities, in the form of corporate promissory notes.[4] Specifically these defendants are charged with misrepresenting to the purchasers that the notes in question were rated prime by the National Credit Office (hereinafter N.C.O.), a division of Dun & Bradstreet. The purchasers allegedly misled by these misrepresentations include the Treasurer of the State

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[4] Section 17(a) of the 1933 Act provides as follows:

(a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

15 U.S.C. § 77q(a).

Corporate and personal promissory notes are, of course, included within the definition of "securities" within the meaning of both the 1933 and 1934 Acts. See Section 2(1). Securities Act of 1933. 15 U.S.C. § 77b(1); Section 3(10), Exchange Act of 1934, 15 U.S.C. § 78c(10); also see Tcherepnin v. Knight, 398 U.S. 332, 88 S.Ct. 548, 19 L.Ed.2d 564 (1967); Farrell v. United States, 321 F.2d 409 (C.A. 9, 1963), cert. den. 375 U.S. 992, 84 S.Ct. 631, 11 L.Ed.2d 478 (1968); Anderson v. Francis I duPont & Co., 291 F.Supp. 705 (D.Minn., 1968); Withlow and Associates Limited v. International Brokers, Inc., 252 F.Supp. 943 (D.Haw., 1966); S.E.C. v. Addison, 194 F.Supp. 709 (N.D.Tex. 1961)

of Ohio and the Industrial Commission of Ohio, acting for the account of Ohio's Disabled Workmen's Relief Fund. (Complaint, Paragraph 25). The plaintiff Commission further alleges in Count I that these same defendants omitted to state material facts in the course of the various note transactions which, in light of other statements made, rendered such omissions misleading. See Section 17(a)(2), Securities Act of 1933. The alleged omissions include, but are not limited to, the following: (1) Substantial portions of the monies obtained through the sale of the promissory notes in question were reloaned to various individuals and corporations; although the reloaning was agreed to before the notes were sold, this information was not brought to the purchaser's attention; (2) King Resources Company, at the time it sold the notes in question, was not meeting its current obligations to creditors as they matured; and (3) Four Seasons' income and sales for the six month period ending December 31, 1969, and for the first quarter (January, February and March) of 1970 were substantially overstated. (Complaint, Paragraph 26). Count II of the Complaint incorporates these same factual allegations within the legal context of Section 10(b), 15 U.S.C. § 78j(b) and Rule 10b-5, 17 C.F.R. 240.10b-5, promulgated thereunder, of the Exchange Act of 1934.[5]

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[5] Section 10(b) of the Exchange Act of 1934 provides as follows:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate

Counts III and IV of the Complaint are directed against LCM Corporation, Lore and the Crofters defendants.[6] Count III charges these defendants with

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commerce or of the mails, or of any facility of any national securities exchange—

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 10b(5) to the Securities and Exchange Commission, promulgated pursuant to their rule making authority conferred by Section 10(b), above, provides as follows:

> Rule 10b-5. Employment of Manuplative and Deceptive Devices
>
> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange.
>
> (1) to employ any device, scheme, or artifice to defraud.
>
> (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceipt upon any person, in connection with the purchase or sale of any security.

[6] As used in this opinion Crofters will refer to and subsume the corporate entity so named, in addition to Deegee Company, Regency Acceptance and the individual defendants, Donahue, Griffith and Groban. We do this because of the substantial identity of the parties. See part I of this Opinion and Order, *supra*, at p. 240-242.

violating Section 17(a) of the 1933 Act by misrepresenting to purchasers, including SERS, that certain promissory notes which were offered for sale were the notes of local housing agencies, when in fact they were not. (Complaint, Paragraph 29). The Crofters defendants are further charged under this Count with failing to inform the purchaser of these notes of the one-half interest they were to receive from the prospective real estate developments of certain borrowers, in addition to a customary fee. (Complaint, Paragraph 30). Count IV reiterates these factual allegations within the purview of Section 10 (b) and Rule 10b-5.

Count V is directed solely against the Crofters defendants and charges them with conducting an interstate business as broker-dealers in securities, without registering with the S.E.C. under Section 15(b) of the 1934 Exchange Act, in violation of Section 15 (a) of said Act, 15 U.S.C. §78*o*(a) and (b). Plaintiff Commission now seeks an injunction against all defendants to permanently enjoin the aforementioned acts.

III

Factual Setting of this Controversy

The factual pattern in this case is elaborate because of the large number of defendants and the numerous transactions in which they were involved. For the limited purpose of this Order, and on the basis of the parties' briefs and the depositions filed herein, the following will be assumed.

(a)

General Background to the Loans

In August and September of 1969 defendants Donahue, Griffith and Groban formed defendant Deegee and incorporated defendant Crofters. Donahue, a Columbus attorney (as is Griffith), had been First Assistant Attorney General and Tax Commissioner of Ohio. Groban, prior to his association with Crofters, was involved with numerous enterprises including the financing business. Between the fall of 1969 and the spring of 1970 defendant Crofters helped arrange the sale of $22,000,000 of promissory notes of various corporations to the State of Ohio, through the State Treasurer's Office and Ohio's Workmen's Compensation Fund.

At the time these transactions were consummated both the Treasurer and the Fund were restricted by statute from utilizing the investment funds administered by them in certain types of investments. The Treasurer had legal authority, pursuant to O.R.C. § 135.14, to invest no more than $50,000,000 of "interim funds" in commercial paper rated "prime" by N.C.O., a division of Dun & Bradstreet.[7] Commercial

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[7] O.R.C. § 135.14 relating to the "Investment of interim moneys" provides, in material part, as follows:

> The treasurer or governing board may invest or deposit any part or all of the interim moneys, provided that such investments will mature or are redeemable within two years after the date of purchase. The following classifications of obligations shall be eligible for such investment or deposit:

[Footnote continued on page 40a]

paper is commonly and customarily regarded in the securities industry as an unsecured promissory note with a maturity term not exceeding 270 days, the proceeds of which are used for working capital purposes. (See Merker dep., p. 12).[8] Only notes possessing these characteristics are rated by N.C.O. Other mercantile agencies rate non-commercial paper and longer term bonds and debentures. The Workmen's Compensation Fund was restricted by state law to investments in corporate notes certified by one of the standard rating services "to be of investment equivalent to, or higher than, the quality of bonds rated in

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[7] [Continued]

(A) Bonds, notes, or other obligations of or guaranteed by the United States, or those for which the faith of the United States is pledged for the payment of principal and interest thereon;

(B) Bonds, notes, debentures, or other obligations or securities issued by any federal government agency, or the export-import bank of Washington:

(C) Interim deposits in the eligible institutions applying for interim moneys as provided in section 135.08 of the Revised Code. . . .

(D) Bonds and other obligations of this state.

In addition to the investments specified in subparagraphs (A), (B), (C), and (D) of this section, the treasurer of state may invest interim moneys of the state in commercial paper notes issued by any corporation for profit which is incorporated under the laws of the United States, a state, or the District of Columbia, which such notes are rated prime by the National Credit Office, Inc., New York, or its successor, provided that the aggregate total amount of interim moneys invested in commercial paper at any time shall not exceed fifty million dollars.

[8] Merker was at all times material herein, vice-president in charge of N.C.O.'s Commercial Paper Division.

the third highest investment classification." Workmen's Compensation Law of Ohio, O.R.C. § 4123.44.

(b)

The Whittaker-Vector and I.H.C. Loans: Counts I and II

The first note transaction occurred on August 28, 1969. On that date the Treasurer's Office of the State of Ohio purchased a two-year $5,000,000 note of the Whittaker Corporation and its wholly owned subsidiary, The Vector Company, Inc. The parties to this transaction were defendant Donahue and Gardner, who was at that time Deputy Treasurer of the State. Gardner, in testimony before the state's Auditor's Office, has testified that Donahue represented that the note had been rated prime by N.C.O. Merker, however, has testified that neither Whittaker nor Vector had ever sought or obtained a prime rating from N.C.O. (Merker dep., p. 141). There is nothing in the Crofters defendants' brief in support of their motion for summary judgment which explains this particular sale. Vector paid defendant Regency Acceptance Company $75,000 for Donahue's services in connection with the sale. Defendants Donahue and Griffith each received $25,000 of this amount.

On September 26, 1969 Whittaker and Vector sold a two-year $2,000,000 promissory note to the state Treasurer's Office. Again, the arrangements for this sale were made between Donahue and Gardner and, according to Gardner's testimony, the note was represented by Donahue as prime. As noted above,

neither of these two companies ever submitted their financial data to N.C.O. for the purpose of being rated for the commercial paper market. Vector paid $25,000 to Regency Acceptance Company for Donahue's services in connection with this sale and each of the Crofters principals received one-third of this amount. See Hegan affidavit dated November 13, 1970, paragraphs 10 and 11; attached to plaintiff's memorandum in support of motion for preliminary injunction.

On October 16, 1969, the state Treasurer's Office purchased a two-year $2,000,000 promissory note of I.H.C. Corporation. Arrangements for this loan were made by Donahue with Deputy Treasurer Gardner. According to Gardner's testimony before the Auditor's Office, Donahue told him the note was rated prime. (Gardner's dep. before the Auditor's Office dated May 20, 1970, p. 11). Merker has testified that I.H.C. never requested a rating from N.C.O. on its commercial paper (Merker dep., p. 141). The Crofters defendants have not countered the allegations pertaining to this transaction in their pleadings before this Court. I.H.C. paid Deegee a $70,000 fee for services rendered in connection with this transaction. See Hegan affidavit, *supra*, paragraph 12.[9]

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[9] It should be noted at this point that S.E.C. has not made Whittaker, Vector, I.H.C. or Deputy Treasurer Gardner party defendants to the instant injunctive proceedings.

(c)

The Consolidated Loans

The Court takes notice of the following, essentially uncontraverted facts, as they relate to the Consolidated loan transactions. Defendants Trueblood and Kerr had been social and business acquaintances for many years prior to January, 1970. Both were aware of and had conversations relating to the general tightening of the capital markets which began in the late 1960's and continued into the 1970's. (Trueblood dep., pp. 6-12). In the early part of January, 1970, defendant Howard called Kerr and told him that he had located a substantial source of long-term money for his company's needs. (Kerr dep., pp. 11-13). In a subsequent phone call Howard told Kerr that $1,000,000 was immediately available and that additional sums would become available in the future. Howard informed Kerr at this time that the requirements for obtaining these loans included a net corporate assets of $25,000,000 and being listed and traded on one of the two major New York stock exchanges. Regency Income did not satisfy the second of these requirements. (Kerr dep., p. 14).

In the early part of the week of January 19, 1970, Kerr called Trueblood and informed him of the conversations he had had with Howard, and of the requirements for borrowing money from the State of Ohio. During the course of this conversation Kerr asked Trueblood if Consolidated would consider reloaning to Regency Income a portion of the money

it might borrow from Ohio. Trueblood told Kerr that he would consider such an arrangement but that it would depend on Consolidated's money needs and that the reloaned money would bo subject to immediate recall. (Trueblood dep., pp. 6-8). Trueblood also indicated that Regency Income would be responsible for a part of the fees, if any, incurred in making the loan. At the time of this conversation Kerr knew that Trueblood had been seeking additional sources of capital (Trueblood dep., p. 11).[10] Trueblood then sent copies of certain financial information and other data to Groban in Columbus. (Exhibit 13 to dep. of Groban).

Subsequently, during the week of January 19, 1970, Kerr recontacted Trueblood and told him that $1,000,000 was immediately available for a two-year term at 9½% interest. After discussing the matter with Consolidated's Executive Board, Trueblood told Kerr that his company was willing to borrow the money from the State of Ohio and reloan the entire amount to Regency Income. The terms of Regency's note to Consolidated were to be identical to those of Consolidated's note to Ohio. Trueblood, however, did insist that Kerr agree to two conditions: (1) Regency Income was to pay all expenses incurred and prepare all the documentation involved in connection with the loan from Ohio. (2) The money reloaned to Regency was to be subject to immediate

[10] Kerr had already agreed to reloan a portion of any monies received by Regency Income from Consolidated to Howard. See Kerr dep., at 30.

recall by Consolidated. (Trueblood dep., p. 20). Kerr agreed to these conditions and told Trueblood to expect a call from Groban. (Trueblood dep., p. 24).

On January 23, 1970, Groban called Trueblood who was not then in his office. Later that day Gutjahr, Consolidated's treasurer, on Trueblood's direction, returned Groban's call. (Trueblood dep., p. 32). Groban told Gutjahr that it was necessary for Consolidated to obtain a prime rating from N.C.O. in order to borrow money from Ohio. Gutjahr was further advised to contact Merker about the details and requirements for obtaining such rating from N.C.O. (Gutjahr dep., pp. 11-13). During January 23, 1970, Groban called Merker, identified himself as vice-president of Crofters, and expressed an interest in N.C.O.'s commercial rating service. He further told Merker that Crofters was interested in obtaining a rating for its client, Consolidated, for the commercial paper market. Merker has testified that Groban told him that the notes Consolidated intended to issue had a term of 120 days. (Merker dep., pp. 22-26). Groban denies that he ever made such a representation. See affidavit of Harry Groban dated April 20, 1972 at p. 2, attached as Document #3 to Crofters brief in support of motion for summary judgment. A question of fact exists as to this conversation.

Later on the same day Gutjahr called Merker. Merker outlined the documents that Consolidated would have to submit in order for N.C.O. to appraise the company's liquidity for the purpose of rating

its commercial paper. The papers requested by Merker included financial statements, prospectuses and the names of Consolidated's banks.[11] These documents were sent to Merker by Gutjahr on January 23, 1970 (Gutjahr dep., pp. 11-17; and Exhibit 18A to Gutjahr's deposition). Gutjahr had no discussion with Merker concerning the terms or amounts of the notes that were to be issued (Gutjahr dep., pp. 16-17). Consolidated was informed by letter of January 27, 1970, from Merker to Gutjahr, that it had been rated prime for the commercial paper market. (Exhibits to deposition of Kerr).

Pursuant to its agreement with Trueblood, Regency Income, through its house counsel Crew, prepared a promissory note for Consolidated to sell to the State of Ohio. Crew also prepared a form of resolution of the Executive Committee of Consolidated authorizing the transaction with Ohio, and appointing Crew as attorney-in-fact to act on behalf of Consolidated in connection with such transaction. The note and resolution were executed and certified by Consolidated's Executive Committee and given

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[11] It should be noted, as to all of the transactions discussed, *infra*, that N.C.O. does not rate specific pieces of commercial paper. At no time material herein did N.C.O. see the notes actually sold by Consolidated, Four Seasons and King Resources to the State of Ohio, and there was no requirement that these notes be submitted to N.C.O. for its inspection. An N.C.O. rating is designed to reflect a company's liquidity and ability to redeem its commercial paper. N.C.O. rates companies and not the individual notes of these companies. Its highest rating is prime, followed by ratings of desirable, satisfactory, fair and no rating.

to Crew for delivery to the Treasurer of the State of Ohio. (Trueblood dep., p. 28; Exhibits 9 and 12 to Gutjahr's deposition). Crew took the documents to Columbus, Ohio and the transaction was closed January 29, 1970, in the office of Ohio's Treasurer. In addition to Crew, Groban and Gardner were present at the closing. The note bought by Ohio was to come due January 28, 1972.

After the closing Crew returned to Groban's office. Groban tendered Crew an invoice of Deegee Company addressed to Consolidated, in the amount of $40,000, for services rendered in connection with this transaction. (Crew dep., pp. 23-29). On January 30, 1970, C. Darby Smith, vice-president of Regency Income, brought to Gutjahr a two-year note from Regency, as payor, to Consolidated, as payee, dated January 29, 1970 for $1,000,000 at 9½% interest. Consolidated then delivered its check to Regency in the amount of $1,000,000 (Gutjahr dep., pp. 51-52). Deegee's invoice for $40,000 was then paid by Regency Income which, pursuant to a prior agreement, reloaned Howard's $250,000. Howard in turn paid Regency $10,000 for lending him that sum.

Sometime in the middle of February, 1970, Howard reported to Kerr that an additional $2,000,000 loan might soon become available from the State of Ohio (Kerr dep., p. 23). Kerr was informed that this loan would be for a term of one year at 9% interest. Kerr relayed this information to Trueblood, on or about February 16, 1970, and asked him if Consolidated was willing to borrow the full amount

and reloan half of it to Regency Income. Trueblood soon accepted Kerr's request with the understanding that the two conditions which pertained to the first transaction (see, *supra*, at p. 246) would also be applicable to the second. (Trueblood dep., pp. 45-47). On February 17, 1970, Crew brought a $2,000,000 promissory note to Consolidated's offices. He also prepared and brought a form of resolution of the Executive Committee of Consolidated authorizing the transaction and appointing Crew attorney-in-fact in connection with this transaction. These documents were executed and certified and given to Crew for delivery to the Treasurer of the State of Ohio. (Crew dep., pp. 33-35). The closing of this transaction took place on February 18, 1970 and was similar to the first closing. (Crew dep., pp. 37-38). Crew was handed a Crofters invoice in the amount of $50,000. This sum was paid by Consolidated which was later reimbursed for one-half of the amount of Regency Income. (Crew dep., pp. 40-42).[12] On or about Febru-

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[12] The source of funds for the second loan was Ohio's Workmen's Compensation Fund. Under state law the Fund could invest surplus monies in corporate notes provided that note was certified in writing by one or more of the standard rating services "to be of investment quality equivalent to, or higher than, the quality of bonds rated in the third highest investment classification." O.R.C. § 4123.44. In this connection, Groban called Merker and asked him to compare N.C.O.'s prime rating with Standard & Poor's Bond Rating (Merker dep., p. 46). On February 10, 1970 Merker wrote Groban informing him that Consolidated's prime rating was "higher than the third highest [bond] investment classification." This letter was forwarded to the Administrator of the Fund. Since

ary 19, 1970, Regency's vice-president, Smith, brought to Gutjahr a one-year note from Regency, as payor, to Consolidated, as payee, dated February 18, 1970 in the principal amount of $1,000,000 at 9% interest. Consolidated delivered to Regency its check for $1,000,000 (Gutjahr dep., pp. 96-97). Regency then, pursuant to a prior arrangement, reloaned $125,000 of the sum it borrowed to Howard. In neither of these loan transactions did Consolidated or any of the other ultimate parties to these transactions disclose to either Ohio's Treasurer or Workmen's Compensation Fund their intent to reloan or to borrow substantial portions of the money obtained from these state agencies.[12]

On May 19, 1970, following a series of newspaper articles concerning Ohio's loan program, the American Stock Exchange suspended trading in Consolidated stock. The S.E.C. ordered a further suspension

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the three highest bond classifications are AAA, AA and A, Merker's letter indicated that an N.C.O. rating of prime was equivalent to a bond rating of between A and AA.

[12] On or about May 15, 1970 Consolidated was requested by James Dayton, Cashier, Office of the Treasurer of the State of Ohio, to redeem its two-year note and substitute therefor a 270 day obligation. Trueblood and Consolidated's Executive Committee agreed to this and so informed the Treasurer's Office on May 20, 1970 (Trueblood dep., pp. 59-63). In May, 1970, Trueblood informed Kerr that Consolidated had need of the $2,000,000 lent Regency. Regency repaid Consolidated on May 25, 1970 with two checks, one postdated June 10, 1970, the full principal and interest due on the loans. On February 16, 1971, Consolidated fully repaid the principal and interest due on its notes to the State of Ohio.

of trading in Consolidated stock on May 28, 1970. After an investigation and as a prerequisite for the resumption of over-the counter trading in its stock, Consolidated was required by the S.E.C. to disclose the facts and circumstances surrounding its Ohio loans. On June 5, 1970, Trueblood sent a letter, under his signature, to the shareholders of Consolidated among others. The contents of this letter, as it relates to the Ohio transactions, fails to disclose the reloaning of the bororwed money to Regency, although it does refer to the fees paid to Crofters.[13a]

(d)

The King Resources Loans

The Treasurer of the State of Ohio also bought two promissory notes of defendant King Resources. The first, dated April 17, 1970, was for $3,000,000 and a term of two years, the second, dated May 1, 1970, had the same term as the first and was for $5,000,000. King Resources learned of Ohio's investment policies through, once again, Mr. Howard. Howard was introduced to defendant Coffey, vice-president of King Resources, in February of 1970. He told Coffey that he knew of a source of long-term funds which were available on a one, two and five-year basis. Howard further informed Coffey that it was necessary that King Resources have an N.C.O.

[13a] See Exhibit 12 to Hegan affidavit, *supra*, attached to plaintiff's memorandum in support of motion for preliminary injunction.

rating of prime on its commercial paper as a prerequisite to borrowing money from Ohio. (Coffey dep., pp. 7-19).

On February 19, 1970, Groban instructed Coffey to send him certain financial information and banking references. Coffey complied with this request. (Coffey dep., pp. 21-22). In the latter part of February, 1970, Groban called Merker and asked N.C.O. to rate King Resources for the commercial paper market. During the course of this conversation Groban, according to Merker's testimony, represented that the commercial paper King Resources intended to issue was for a term of 120 days and in the amount of $2,000,000. (Merker dep., pp. 87-89). Groban denies that he ever made such a representation. As we have noted above, in regards to a similar conflict in testimony concerning the Consolidated loans, a factual question is raised by this inconsistency.

Because N.C.O. had no file on King Resources, Merker called Coffey and requested him to submit the customary financial data and documentation. (Merker dep., p. 89). Upon receipt of the requested information and investigation thereof, Merker, in a letter to Groban dated February 26, 1970, rated King Resources prime for the commercial paper market. Groban gave a copy of this letter to Gardner and the loans to King Resources were closed as detailed above. King Resources, pursuant to an agreement entered into before the loans were consummated, reloaned $1,500,000 to defendant Colorado Corporation. The details of this agreement were not

disclosed to officials of Ohio's Treasurer's office before the loans were closed. Deegee received a $120,000 finder's fee from King Resources for services rendered in connection with the first loan. Groban has testified that no fee was paid to the Crofters defendants in connection with the second loan, pending their efforts to locate additional money for King Resources (Groban SEC tr., p. 68). Negotiations for the King Resources loans were carried out between Gardner and Groban. (Testimony of Gardner in State of Ohio v. Donahue, et al., No. 49,143, Court of Common Pleas of Franklin County, Ohio, at pp. 21-22, 29; attached to Gardner's affidavit, Document #6 to Crofters brief in support of motion for summary judgment.)

(e)

The Four Seasons Loans

Defendant Clark, Four Seasons' former president, learned of Ohio as a source of financing in January, 1970, through David Ehlers of the Gibraltar Growth Fund. Ehlers told Clark that defendant Howard would contact him and further explain the procedure for borrowing money from Ohio. (Clark dep., March 24 and 25, 1971, pp. 12-15). A meeting between Clark and Howard took place in Oklahoma City during February, 1970. At this meeting Howard told Clark that Four Seasons qualified to borrow as much as $25-30 million from Ohio and that the state's money was available for two to five year loans at interest of 8½% to 9½%. Clark agreed at this

time to reloan Howard 20% of any funds borrowed from Ohio at 1% above the interest rate that Four Seasons would be paying to the state, and for an identical term. (Clark dep., p. 28). Howard requested and received from Clark several copies of Four Seasons' annual report and sent four copies to these, along with the corporation's latest interim report, to Groban.

Groban showed the financial information he had received from Clark to Gardner. Although Gardner was concerned that these financial reports revealed considerable assets as account receivables,[14] he told Groban that he would authorize a loan to Four Seasons if it obtained a prime rating from N.C.O. (Groban SEC tr., pp. 28-29; Gardner dep., pp. 10, 27-28, 32-33).

On February 18, 1970, Groban telephoned Merker and told him that he wanted a commercial paper rating for Four Seasons for the commercial paper market. (Merker dep., p. 59). Merker has testified that Groban told him that the proposed amount of the Four Seasons paper was $1,000,000 for a term of 120 days. (Merker dep., p. 59). Groban has denied

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[14] Four Seasons annual and interim reports reflected assets receivables of approximately $9,000,000 as of June 30, 1969 and approximately $30,000,000 as of December 31, 1969 (Groban SEC tr., July 1, 1970, pp. 28-29; Gardner dep., June 2, 1971, pp. 11-13). The plaintiff Commission maintains and defendant Clark denies that these receivables were substantially overstated. (See Eichstaedt affidavit filed in support of plaintiff's motion for preliminary injunction; (Clark's memorandum in support of motions to dismiss and for summary judgment, pp. 39-46).

making this statement, again presenting this Court with a question of fact which cannot be resolved on motion. Groban told Merker to contact John Mee, Jr., Four Seasons' vice-president and general counsel (Merker dep., p. 61), who along with Alex Russell, Four Seasons' comptroller, at Clark's direction, handled all subsequent dealings with Ohio in regard to the loan transactions.

Merker called Mee later during February 18, 1970 and explained that he had received an inquiry from Groban for the purpose of having Four Seasons rated for the commercial paper market. Merker requested that Mee provide N.C.O. with certain financial information respecting Four Seasons. Mee promptly transmitted the requested information to Merker which included a prospectus and annual reports containing financials for the year ending June 30, 1969, an unaudited report for the six months ending December 31, 1969, and bank references. (Merker dep., pp. 61-63). Mee had no discussion with Merker regarding the promissory notes Four Seasons proposed to issue; nor did Merker question him concerning their terms. On March 7, 1970, after examination of the material forwarded and certain additional investigation, N.C.O. rated Four Seasons prime for the issuance of commercial paper and advised Mee and Groban by letter of this rating (Merker dep., pp. 69-70).

Upon receipt of Merker's letter Groban reviewed negotiations with Gardner over the terms and conditions of Ohio's loans to Four Seasons. (Groban

SEC tr., p. 29). Gardner finally agreed to loan $2,000,000 to Four Seasons for 120 days, at the end of which time the loan would be "rolled over" (i.e., converted) into a two-year loan (Groban SEC tr., p. 29; Gardner dep., pp. 18-19, 27-28, 33-34; Gardner SEC tr., June 29, 1970, p. 123). In addition, Gardner agreed to loan Four Seasons $1,000,000 for two years (Gardner dep., p. 28), and further indicated to Groban that an additional state loan to the corporation could be obtained at the end of March, 1970, for a two-year term (Groban SEC tr., p. 29). No one disclosed to Gardner that, pursuant to Clark's agreement with Howard, 20% of the proceeds obtained from Ohio were to be reloaned to Howard (Gardner SEC tr., p. 76).

Groban then telephoned Howard to report the results of his negotiations with Gardner, apprising him of the loan terms and the amounts available (Groban SEC tr., p. 29). In early March, 1970, Howard informed Clark of the data and terms of the proposed loans from Ohio. After subsequent conversations between the parties to these loans a closing was set for March 9, 1970. On that date Russell, in Groban's presence, delivered three promissory notes of Four Seasons totaling $3,000,000 to Gardner (Groban SEC tr., p. 32). These notes were originally made payable to the Workmen's Compensation Fund but were redrawn and made payable to the State Treasury at Gardner's insistence.[15] A second closing involving the

[15] Clark has argued that because O.R.C. § 4123.44 does not require a prime rating, and because he was obviously expect-

additional note for $1,000,000 for two years was purchased by Ohio on March 23, 1970. The closing for this note was handled by mail pursuant to arrangements made by Gardner at the March 9, 1970 meeting with Groban and Russell.

Four Seasons reloaned $800,000 (less 4 points or $32,000) of the $4,000,000 it received from the State of Ohio to Howard's company, Financial Data Relations, Inc. (Clark dep., pp. 62, 76-77). In addition, Four Seasons paid Deegee $160,000 for its services in connection with the aforesaid loan transactions. (Groban SEC tr., p. 31).

(f)

The SERS Loans:
Counts III and IV

Between August, 1969 and January, 1970, the Crofters principals arranged for and helped effectuate the sale of various promissory notes to SERS. Under Ohio law, SERS can invest in, among other things, "obligations of local housing agencies . . ." O.R.C.

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ing to borrow from the Fund as indicated by the notes as originally drawn, he would not have had any reason to defraud N.C.O. in order to obtain a prime rating. See Clark's memorandum in support of motion for summary judgment, p. 13 n. 1. However, there is nothing in the record which affirmatively indicates that Clark expected at the time Four Seasons obtained the prime rating that he was to deal with the Fund; there is no indication that he made any distinction between the two, separate sources of state monies. The original, unused notes payable to the Fund were redrawn without apparent protest.

§ 3309.15(A)(3).[16] Lore, a non-moving defendant, was until October, 1969, the investment officer of SERS and thereafter, until January, 1970, its special consultant. During this period Lore had authorization from SERS' board to issue letters of commitment on behalf of the board. The board would meet every three to four weeks to review and ratify Lore's investment decisions. Lore was also authorized to prepare interim SERS Board Resolutions authorizing a given loan so that the borrower could receive his first payment from the state's Treasury. The promissory notes given in return for these advances and commitments were not cosigned, as required under state law, by various local housing agencies. However, in his "Summary of Investment Transactions" that he prepared from time to time for presentation to the SERS board, Lore described the notes that SERS was committed to buy from Crofters as

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[16] O.R.C. § 3309.15(A)(3) provides in relevant part as follows:

> The members of the school employees retirement board shall be the trustees of the several funds created by section 3309.60 of the Revised Code. The board may invest such funds in any bonds, notes, certificates of indebtedness, mortgage notes, stocks, shares, debentures, or other obligations, or securities described below:
>
> (A) The following obligations of the federal government and related agencies: . . .
>
> (3) Obligations of local housing agencies which obligations are secured either by a requisition agreement or by an annual contributions contract by and between the local housing agency and the public housing administration . . .

"local Housing Agency Notes." (See Exhibit 6 to the affidavit of Donald Dreyfus dated November 13, 1970 attached to plaintiff's memorandum in support of motion for preliminary injunction).

Under this arrangement SERS through Lore committed itself to buy $28,766,850 worth of promissory notes of individual or corporate borrowers. The Crofters defendants received cash fees totalling $605,000 for arranging the sale of these various promissory notes. Defendant, LCM, a corporation controlled by Lore, received $47,831.25 in fees from Crofters for services rendered in connection with obtaining the commitments from SERS. During the time these commitments were obtained LCM was renting office space and occupying a portion of Crofters' suite. Of the amount committed by Lore or his successor, $19,526,850 was ratified by the SERS board and $4,000,000 was actually disbursed before the board ordered an investigation into these loans. Crofters notes in its brief in support of its motion for summary judgment, that as moneyfinders they "were interested only in a source that would provide a letter of commitment. For this they were paid." At 21.[17]

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[17] In total Crofters obtained commitments for twenty-five construction projects for twelve developers. As noted, the amount of these commitments was $28,766,850. The standard fee Crofters charged for obtaining these commitments averaged between two and four points. However, in three loans Crofters required the borrowers to enter a joint venture with them, under which they received a one-half interest in the building projects. The estimated cost of the projects covered

IV

OPINION

(a)

The N.C.O. Ratings

Lying at the very heart of the S.EC.'s complaint is the question of whether the defendants (with the exception of defendants Lore and LCM) violated Sections 17(a), 10(b) and Rule 10b-5 of the securities laws, either through their acts or omissions, in obtaining prime ratings from N.C.O. It must be kept in mind that a prime rating from N.C.O. is an irreducible statutory requirement that must be satisfied by corporate borrowers before they may be eligible to receive funds from the State Treasury. See n. 7, *supra*.

Under the S.E.C.'s view of this case the fraudulent obtaining of prime ratings by Consolidated, King Resources and Four Seasons, as assisted by the other defendants, was the lubricant which allowed the alleged fraud against Ohio to proceed smoothly. The Commission contends that this alleged fraud was furthered by the making of either explicit or implied representations to N.C.O., and to Merker in particular, that the defendant corporations intended to issue

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by these joint venture agreements was approximately $11,760,000. Crofters' interest in these particular projects was not disclosed to SERS (See Exhibit 1 to Dreyfus affidavit, *supra*; Dreyfus affidavit, *supra*, paragraphs 8-14).

commercial paper, whereas in fact they were seeking longer term financing through the issuance of non-commercial paper. As this Court has previously noted, N.C.O. defines commercial paper as an unsecured promissory note with a maturity term not exceeding 270 days, the proceeds of which are used for working capital purposes. (*Supra*, p. 244; Merker, dep., p. 12). The moving defendants counter this argument by noting that commercial paper is not so restrictively defined under Ohio law; that N.C.O. did not give notice of its definition of commercial paper to the corporations that requested ratings and consequently the various defendants were ignorant of such a definition; and that since N.C.O. rates companies, and not the individual notes issued by these companies and because the companies were properly rated prime, no fraud was committed by the obtaining of these ratings.

The first question before this Court is whose definition of commercial paper should govern the law of this case. Our analysis of this issue must begin with the plain words of O.R.C. § 135.14. As indicated above, this statute authorizes the state Treasurer to invest in commercial paper notes issued by private corporations where "such notes are rated prime by the National Credit Office, Inc., New York . . ." *supra*, n. 7. It should by now be obvious that this statute contains a latent error insofar as N.C.O. does not rate individual notes but rather a company's ability to redeem the commercial paper notes it issues. But if anything, by making reference to the

rating of individual notes as opposed to entire companies, this statute imposes a heavier duty on the prospective issuer than the one the defendants at bar are willing to assume. The statute appears to contemplate that investments in the notes of corporations for profit are inherently of higher risk than are the investments authorized by O.R.C. § 135.14(a), (B), (C) and (D). See, *supra*, n. 7. Even a casual reading of the statute discloses that whereas the Treasurer was permitted to invest freely in obligations of the United States and the State of Ohio maturing within two years, his investments in commercial paper of corporations for profit was limited to notes rated prime by N.C.O. The statute, therefore, seeks to insure that investments in the notes of corporations for profit be certified to be of low risk by an objective rating agency.

Since § 135.14 does not purport to define commercial paper N.C.O.'s definition of this term, if reasonable, must necessarily govern the resulting legal relationships of the parties. The reason for this is that N.C.O. is, by specific statutory reference, Ohio's statutory agent or "designated agency" for this purpose. See, 1970 Opinions of the Attorney General, No. 70-067 at 3.

It is this Court's opinion that N.C.O.'s definition of commercial paper is not unreasonable. It is clearly consistent with, and should be read in conjunction with, Section 3(a)(3) of the Securities Act of 1933, which specifically exempts from the registration requirements of Section 5 commercial paper with a

term of 270 days or less.[18] It is true, as defendants argue, that there is no universally accepted definition of commercial paper as regarding terms of maturity.[19]

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[18] Section 3(a)(3), 15 U.S.C. § 77c(a)(3) provides that:

> (a) Except as hereinafter expressly provided, the provisions of this subchapter shall not apply to any of the following classes of securities: . . .
>
> (3) Any note, draft, bill of exchange, of banker's acceptance which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions, and which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

The S.E.C. has not charged any violation of Section 5 of the 1933 Act, 15 U.S.C. § 77c, which has been referred to as "the heart of the statute." 1 Loss, Securities Regulation, 180 (2d ed. 1961). This is so because the transactions in issue were private placements and therefore exempted transactions within the meaning of Section 4(3) of the Act, 15 U.S.C. § 77d(3).

[19] The "Blue Sky" laws of twenty-four jurisdictions contain provisons for exemption from registration similar to Section 3(a)(3), *supra*, in that the maximum maturity for exempt commercial paper is set at nine months. The laws of twenty-one other jurisdictions contain exemptive provisions which either set no limit for the term of exempt commercial paper or else set limits other than nine months. The statutes of Mississippi, Oregon, Pennsylvania and Ohio specify no limit as to term. See, O.R.C. § 1707.02(G). However, O.R.C. § 1101.01(II) of the Banking Laws defines commercial paper as maturing within one year. Commercial paper, generally, is not defined as to maturity in the Uniform Commercial Code, as this is considered a matter for local law. See U.C.C. § 3-104, Comment 1. The S.E.C. does not, it should be noted, allege a violation of Ohio's Securities Law in the instant suit. But even assuming *arguendo* that the one year maturation

Defendants have failed, however, to undercut plaintiff's argument that N.C.O.'s definition is inconsistent with the manner in which commercial paper is generally and customarily regarded both by the securities business and under federal securities law. Judge Bohanon, in denying Ohio's petition for reclamation in The Matter of Four Seasons, 329 F. Supp. 647, 651 (W.D.Okl., 1971) discussed *infra*, pp. 259-261) underscored the customary definition of this term when he noted:

> The commercial paper rating given by [N.C.O.] is really of no significance in this case because in truth and in fact the State of Ohio purchased no commercial paper from the [defendant] corporation. All of the paper purchased by Ohio was for a period of two years which is not commercial paper (Finding of Fact No. 10, *supra*) (Appendix B to Consolidated's memorandum in support of motion for summary judgment).

Unless terms are legislatively or judicially defined courts will generally accept the definition customary in the relevant industry. See Hart and Sacks, The Legal Process, Problems 1, 13, 14 and passim (tent.ed. 1958). Custom, from the time of the ancient Law Merchant to this day, has been one of the major sources for the development and invigoration of the law. In the absence of contrary legislative edict or

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definition of commercial paper contained in O.R.C. § 1101.01 (11), *supra*, were applicable, it would be little aid to the defendants herein, as the great majority of defendants' loans were for terms greater than one year.

judicial precedent, it is generally considered to be binding upon the courts. See Gillarde Co. v. Martinelli & Co., 168 F.2d 276 (C.A.1, 1948), opinion amended on rehearing, 169 F.2d 60 (C.A.1, 1948), cert. den. 335 U.S. 885, 69 S.Ct. 237, 93 L.Ed. 424 (1948); Dixon, Irmaos & CIA, Ltda. v. Chase National Bank, 144 F.2d 759 (C.A.2, 1944), Hart and Sacks, The Legal Process, passim. Only when the custom of a given industry is deemed negligent in the light of subsequent technological developments will judicial law override industry custom. See The T. J. Hooper, 60 F.2d 737 (C.A.2, 1932) (*per* L. Hand, J.).

These principles are now embodied in the Uniform Commercial Code. See U.C.C. § 1-205(2), (3) and (4). In the absence of express terms modifying a usage of trade, the customs of the industry, at the place where any part of the agreement is to be performed, will govern and will be respected by the courts. See U.C.C. § 1-205(4) and (5). Because § 135.14 requires prospective borrowers be rated prime by the standards of the national securities industry in general and by N.C.O., a New York corporation, in particular; and because there was no express modification of these standards by the defendants at bar, they should be held to knowledge of the general definition of commercial paper as used by N.C.O. Legal definitions of this term in other jurisdictions are therefore irrelevant in determining whether the defendants violated the federal securities laws. The fact that neither Merker nor N.C.O.

clarified their definition of commercial paper to the defendants is equally without legal relevance. Persons proceed in ignorance of law, including securities law, at their own peril. The burden of avoiding a mutual mistake as to the definition of commercial paper was upon the various defendants who had dealings with N.C.O. It was to their advantage to redress any failure of communication.
tage to redress any failure of communication.

Since the loans involved in this suit were authorized under a specific statutory provision, the express standards as set forth in that statute must be deemed controlling. The standard embraced by and incorporated by reference into O.R.C. § 135.14 is the one employed by N.C.O. Since there is nothing arbitrary or unreasonable about N.C.O.'s definition of commercial paper but as it is, instead, collaterally supported both by Section 3(a)(3), *supra*, and by the custom of the national security industry, it must be afforded appropriate deference. N.C.O. defines commercial paper as having a term not to exceed 270 days and this Court accepts that definition.

None of the notes issued by the corporate defendants in the action at bar satisfied N.C.O.'s definition of commercial paper. N.C.O. only rates companies for the purpose of redeeming commercial paper of nine-month terms or less. When a company issues a note of a term in excess of nine months, the prefix "prime" is not properly affixed to such a note, and

N.C.O. has not necessarily assessed the company's long term financial prospects. Other Wall Street agencies, which rate long-term paper and bonds, exist to perform this separate function. Merker has testified that if he had known that the defendant corporations were intending to issue notes of a term in excess of 270 days, N.C.O. would not have rated them for the commercial paper market (Merker dep., pp. 86, 260-61). It is clear from the record now before us that the various defendants were interested in obtaining long-term financing for periods in excess of nine months. (See *supra*, pp. 245, 248-250).

On the state of facts now before us, the Court concludes that for the defendants to use the word "prime" in connection with non-commercial paper notes was to employ that term in a manner for which it was not intended. The borrowers knew or should have known that such an impermissible use would tend to confuse and mislead prospective purchasers. Such conduct is violative of the spirit and underlying policies of the federal securities law. See Affiliated Ute Citizens v. United States, 406 U.S. 128, 92 S.Ct. 1456, 31 L.Ed.2d 741 (April 27, 1972); Superintendent of Insurance v. Bankers Life & Casualty Co., 404 U.S. 6, 92 S.Ct. 165, 30 L.Ed.2d 128 (1971); Securities & Exchange Commission v. Capital Gains Research Bureau, 375 U.S. 180, 186, 84 S.Ct. 275, 11 L.Ed.2d 237 (1963).

Accordingly, on the state of facts now before us, the Court concludes that the defendants' use

of the word "prime", as defined by N.C.O. and the custom of the securities industry, in connection with notes of terms in excess of 270 days, constituted a violation of the standard promulgated in O.R.C. § 135.14. Further, that such use of the term "prime", in connection with non-commercial paper tended to operate as a "device, scheme, or artifice to defraud" within the meaning of Sections 17(a)(1) and of Section 10(b) and Rule 10b-5(1) thereunder; and further constituted the engaging in a "transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser" within the meaning of Section 17(a)(3) and Section 10(b) and Rule 10b-5(3) thereunder. See Affiliated Ute Citizens v. United States, *supra*; Securities & Exchange Commission v. Capital Gains Research Bureau, *supra*. This conduct on the part of the defendants constitutes activity which should be enjoined by the equitable powers of this Court. See Britt v. Cyril Bath Co., 417 F.2d 433 (C.A.6, 1969); Securities & Exchange Commission v. Barraco & Company, 438 F.2d 97 (C.A. 10, 1970); Securities & Exchange Commission v. North American Research and Development Corp., 424 F.2d 63 (C.A.2, 1970); Nees v. Securities & Exchange Commission, 414 F.2d 211 (C.A.9, 1969); Brennan v. Midwestern United Life Insurance Co., 259 F.Supp. 673 (N.D.Ind., 1966), aff'd. 417 F.2d 147 (C.A.7, 1969), cert. den. 397 U.S. 989, 90 S.Ct. 1122, 25 L.Ed.2d 397 (1970); Anderson v. Francis I duPont Co., 291 F.Supp. 705 (D. Minn., 1968).

Our view is that the securities laws are to be broadly construed to prevent fraud. Such view is consistent with recent pronouncements by the Supreme Court and with the underlying policies of the Securities Acts. The Supreme Court has recently noted, with reference to Section 10(b) and Rule 10b-5 thereunder, that:

> These proscriptions, by statute and rule, are broad and, by repeated use of the word "any," are obviously meant to be inclusive. The Court has said that the 1934 Act and its companion legislative enactments [including the 1933 Act] embrace a "fundamental purpose . . . to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and this to achieve a high standard of business ethics in the securities industry." Securities & Exchange Commission v. Capital Gains Research Bureau, 375 U.S. 180, 186, 84 S.Ct. 275, 11 L.Ed.2d 237 (1963). In the case just cited the Court noted that Congress intended securities legislation enacted for the purpose of avoiding frauds to be construed "not technically and restrictively, but flexibly to effectuate its remedial purposes." *Id.*, at 195, 84 S.Ct. at 285.

See, Affiliated Ute Citizens v. United States, 406 U.S. 128, at 151, *supra*, 92 S.Ct. 1456, at 1471 (footnotes omitted); also see Superintendent of Insurance v. Bankers Life & Casualty Co., 404 U.S. 6, 92 S.Ct. 165, 30 L.Ed.2d 128 (1971); Securities & Exchange Commission v. Texas Gulf Sulphur, 401 F.2d 833 (C.A. 2, 1968), cert. den., sub nom. Coates v. Securi-

ties & Exchange Commission, 394 U.S. 976, 89 S.Ct. 1454, 22 L.Ed.2d 756 (1969).

The Court in *Affiliated Ute Citizens, supra*, specifically distinguished between violations of Rule 10b-5(2) and the other provisions of that Rule in a manner highly relevant to the instant case. The Court, *per* Justice Blackmun, wrote:

> We conclude, however, that the Court of Appeals erred when it held that there was no violation of the Rule unless the record disclosed evidence of reliance on material fact misrepresentations by Gale and Haslem . . . . *We do not read Rule 10b-5 so restrictively. To be sure, the second subparagraph of the rule specifies the making of an untrue statement of a material fact . . . . The first and third subparagraphs are not so restricted.* These defendants' activities, outlined above, disclose, within the very language of one or the other of those subparagraphs, a "course of business" or a "device, scheme or artifice" that operated as a fraud upon the Indian sellers.

406 U.S. *supra*, at 152, 92 S.Ct. at 1471 (emphasis supplied; also see Superintendent of Insurance v. Bankers Life & Casualty Co., *supra*. Although the underlying facts of *Affiliated, supra*, are readily distinguishable, its general principle is applicable to the case at bar.

We note that our holding on this issue is not dependent on whether Groban actually misrepresented the terms of the various notes to Merker. What is actionable in this case is the use of prime ratings, regardless of how they were obtained, for a purpose which would tend to confuse and mislead the pur-

chasers. Holding as we do, it is unnecessary to consider whether there was a material omission within the meaning of Section 17(a)(2) and Rule 10b-5(2). Defendants had the obligation to insure that the ultimate use of the prime ratings did not violate other provisions of Section 17(a) and 10(b). This obligation on their part might well have cautioned them to reveal that the terms of the various notes they intended to issue were in excess of 270 days and therefore not not properly submitted for a prime rating. Deciding as we do, however, this determination is extraneous to the necessary grounds of our holding.

The defendants who directly participated in obtaining prime ratings for Consolidated, Four Seasons and King Resources knew or should have known that the notes ultimately issued were not properly described by the word "prime." These defendants, namely, the three rated corporations(Consolidated, Four Seasons and King Resources), Crofters, Deegee, Regency Acceptance, Donahue, Griffith and Groban will be held to the standard set forth above and should be enjoined from such further acts in the future. Defendants Trueblood, Clark and King, as responsible officers of the rated companies, should be enjoined for similar reasons. Defendants Regency Income, Colorado Corporation, Coffey, Howard and Kerr will be deemed as aiders and abettors to the deceptive scheme and should also be enjoined.[20] See

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[20] Defendant Kerr's argument that he should not be enjoined because he was a peripheral member of the scheme and because he lacked financial motivation is unpersuasive in light

of Securities & Exchange Commission v. North American Research and Development Corp., 424 F.2d 63 (C.A. 2, 1969). Also see Securities & Exchange Commission v. Texas Gulf Sulphur Co., 401 F.2d 835 (C.A. 2, 1968), cert. den. sub nom. Coates v. S.E.C. 394 U.S. 976, 89 S.Ct. 1454, 22 L.Ed.2d 756 (1969). As these cases indicate acts which are illegal under the securities law, whether motivated by friendship or other non-pecuniary reasons, are properly subject to injunction. Kerr also argues that he did not utilize the facilities of interstate commerce in connection with the Ohio loan transctions. The local use of the telephone satisfies the jurisdictional requirement under Section 10(b) and Rule 10b-5 thereunder since the telephone system is an "instrumentality of interstate commerce" even when the particular telephone conversation does not cross state lines. Lennerth v. Mendenhall, 234 F. Supp. 59 (N.D.Ohio, 1964); Nemitz v. Cunny, 221 F.Supp. 571 (N.D.Ill., 1963); see *contra*, Rosen v. Albern Color Research, Inc., 218 F.Supp. 473 (E.D.Pa., 1963). Trueblood and Kerr first discussed the transactions over the telephone in Denver (Trueblood dep., pp. 6-9, 20).

Two other points should be considered in passing. First, Consolidated, Trueblood, and Kerr argue that since Ohio suffered no monetary loss as a result of the transactions involving Consolidated this action against them should be precluded. This issue is not determinative as this injunction action is directed against certain illegal acts and does not seek to recover funds lost by the State of Ohio. See Otis & Co. v. Securities & Exchange Commission, 106 F.2d 579 (C.A. 6, -939); Securities & Exchange Commission v. Torr, 15 F.Supp. 315 (S.D.N.Y., 1936), reversed on other grounds, 87 F.2d 446 (C.A. 2, 1937); Securities & Exchange Commission v. Capital Gains Research Bureau, *supra*. We note that the state did not fare as well, financially, in some of the other transactions. Second, these defendants contend that the transaction of February 17, 1970 was with the Fund and did not require a prime rating. We note, however, that the Fund did require a certification that a note rated prime was at least equivalent to a bond rated A. Merker made this conversion in his letter to Groban dated February 10, 1970. See n. 13, *supra*, at p. 247. The use of the word prime in this connection in regard to non-commercial paper is equally actionable under the securities laws.

Securities & Exchange Commission v. Barraco, *supra*; Securities & Exchange Commission v. Great American Industries, Inc., 407 F.2d 453 (C.A.2, 1968), cert. den. 395 U.S. 920, 89 S.Ct. 1770, 23 L.Ed.2d 237 (1969); Securities & Exchange Commission v. Culpepper, 270 F.2d 241 (C.A.2, 1959); Anderson v. Francis I. duPont Co., *supra*; Pettit v. American Stock Exchange, 217 F.Supp. 21 (S.D.N.Y. 1963).

(b)

The SERS Loans

On the basis of the evidence now before us (as summarized at pp. 250-251, *supra*), the Court is of the belief that the Crofters defendants, acting in concert with defendants LCM and Lore, violated Sections 17(a), 10(b) and Rule 10b-5, thereunder by failing to comply with O.R.C. 3309.15(A)(3). An injunction should issue on the basis of said evidence.

(c)

Res Judicata and Collateral Estoppel

Various defendants maintain that the present action is barred either by the doctrine of *res judicata* or by the related doctrine of collateral estoppel. The claims of these various defendants will be treated separately below.

(1)

King Resources

Defendant King Resources has moved for dis-

missal of this suit on the grounds that a decree of final judgment of permanent injunction by consent, issued in Securities & Exchange Commission v. King Resources Company, Civil Action No. C-2858 (D.Colo., February 9, 1971) is *res judicata* as to the suit now before the Court. In the Colorado proceedings the S.E.C. sought and successfully obtained a permanent injunction against King Resources enjoining that company from violating Section 5 of the Securities Act of 1933. The injunction further provided that King Resources would not violate Section 17(a) and Rule 10b-5 in connection with the sale of its securities in regard to, but not limited to the following sepcifics:

"(1) the financial condition of the issuer;

(2) present or projected sales or profits from operations of the issuer;

(3) loans made by the issuer;

(4) the financial condition of persons indebted to the issuer;

(5) guarantees of indebtedness owing to the issuer;

(6) lack of authority from the issuer's board of directors for disbursement of monies by the issuer."

Supra, at 3. The S.E.C. now argues that the injunction of the District Court of Colorado does not cover the acts complained of in the present suit. The S.E.C. notes that the Colorado Court merely enjoined King Resources from committing fraud in connection with

the offer or sale of its own securities, while the suit before us seeks injunctive relief against deception in the offer or sale of *any* security. In addition the S.E.C. has further prayed in the present suit for "such other or further relief as the Court may deem necessary or appropriate".

While it is true that a "consent decree will not be expanded beyond the meaning of its terms when read in the light of the issues raised and the purpose for which [the] suit was brought", Great Lakes Carbon Corp. v. Eagle Lumber Dealers Supply Co., 402 F.2d 106, 108 (C.A.7, 1968); Terminal R.R. Assn. of St. Louis v. United States, 266 U.S. 17, 29, 45 S.Ct. 5, 69 L.Ed. 150 (1924); Southern Ry. Co. v. Brotherhood of Locomotive Firemen, 119 U.S.App.D.C. 91, 337 F.2d 127, 136 (1964) we think the Colorado decree can fairly be read to extend to and enjoin the acts now charged against the defendant. The injunction of the Colorado Court, which paraphrases the language of Section 17(a) and Rule 10b-5 may properly be construed to prohibit the acts committed by King Resources which the S.E.C. now wishes to further enjoin. See Mills v. Green, 159 U.S. 651, 16 S.Ct. 132, 40 L.Ed. 293 (1895).

The minor differences between the injunction granted in Colorado and the one sought in this Court are not, in our opinion, of legal significance. The gravamen of the S.E.C.'s present action is to enjoin King Resources from violating the securities laws in regard to *its* securities and this it has already been prohibited from doing by the United States District Court

for the District of Colorado. To the extent King Resources reloaned money to other defendants herein, in violation of Section 17(a)(2) and Rule 10b-5(2), it has now been restrained from continuing to do so in the future. To the extent these other party defendants, having some connection with King Resources were not affected by said injunction, they remain proper parties before this Court. We therefore hold that the injunction issued by the Colorado Court in Securities & Exchange Commission v. King Resources Company, *supra*, is *res judicata* to the present suit, as to that defendant, and may properly be set up as a bar to this action. Mills v. Green, *supra*. The motion for summary judgment of defendant King Resources will consequently be granted.

(2)

The Crofters Defendants

Defendants Donahue, Griffith and Groban and the companies with which they are connected contend that the present action should be dismissed as to them on the grounds of *res judicata* and collateral estoppel. They base this contention on the results reached by two other courts on matters similar to those advanced at bar. See In the Matter of Four Seasons Nursing Centers of America, Inc., 329 F. Supp. 647 (W.D.Okla., 1971) (Memorandum Opinion *per* Judge Bohanon); State of Ohio v. Donohue, et al., No. 49,143, Court of Common Pleas of Franklin County, Ohio, Criminal Division. (Directed ver-

dict of Judge Cook dated March 3, 1972). In the Oklahoma proceeding referred to by these defendants, Judge Bohanon denied the State of Ohio's petition for reclamation brought under Chapter X of the Bankruptcy Act, 11 U.S.C. § 501 et seq., for the reorganization of Four Seasons. This proceeding will be discussed in greater detail in section (3) below. In the Ohio proceeding Judge Cook directed a verdict in favor of the Crofter principals, who were indicted and tried under O.R.C. § 2911.03.[21]

These contentions of the Crofters defendants are without merit. As the Supreme Court of the United States has stated in Lawlor v. National Screen Service, 349 U.S. 322, 75 S.Ct. 865, 99 L.Ed. 1122 (1955):

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[21] O.R.C. § 2911.03 False Statements

No person shall knowingly make or cause to be made, either directly or indirectly, or through any agency, any false statement in writing, with intent that it shall be relied upon, or, knowing that a false statement in writing has been made by another with such intent, respecting the financial condition, property indebtedness, means, or ability to pay, of himself or any other person, firm, or corporation, in which he is interested or for which he is acting, and upon the faith thereof procure, by himself or by some other person for or in collusion with him or with his knowledge, in any form, either the delivery of personal property, or chose in action, the payment of money, the making of a loan or credit, the extension of a credit, the discount of an account receivable, or the making, acceptance, discount, or indorsement of a bill of exchange, promissory note, or other commercial paper, either for the benefit of himself, or such person, firm, or corporation.

> The basic distinction between the doctrines of *res judicata* and collateral estoppel . . . has frequently been emphasized. Thus under the doctrine of *res judicata*, a judgment "on the merits" in a prior suit *involving the same parties or their privies* bars a second suit based on the same cause of action. Under the doctrine of collateral estoppel, on the other hand, such a judgment precludes relitigation of issues actually litigated and determined in the prior suit, regardless of whether it was based on the same cause of action as the second suit. *Id.*, at 326, 75 S.Ct., at 867. (emphasis supplied and footnotes omitted.)

See *accord*, Cromwell v. County of Sac, 94 U.S. 351, 24 L.Ed. 195 (1877); United Shoe Machinery Corp. v. United States, 258 U.S. 451, 42 S.Ct. 363, 66 L. Ed. 708 (1922); Sunnen v. Com'r, 333 U.S. 591, 68 S.Ct. 715, 92 L.Ed. 898 (1948); In re Constructors of Florida Inc., 349 F.2d 595 (C.A.5, 1965); Towle v. Boeing Airplane Co., 364 F.2d 590 (C.A.8, 1966); Cream Top Creamery v. Dean Milk Co., 383 F.2d 358 (C.A.6, 1967); Exhibitors Poster Exchange, Inc. v. National Screen Service Corp., 421 F.2d 1313 (C.A. 5, 1972); also see 1 D Moore's, Federal Practice, ¶¶ 0.405 [1] and [3]; 0.441 [1] and [2].

The Crofters defendants do not present a question of *res judicata*. The injunction action now pending before us is a different and distinct cause of action from those decided by the Oklahoma and Ohio courts. Nor does the defendants' argument fare more suc-

cessfully under collateral estoppel notions. Collateral estoppel has been succinctly defined as follows:

> Where there is a second action between parties or their privies, who are bound by a judgment rendered in a prior suit, but the second action involves a different claim, cause or demand, the judgment in the first suit operates as a collateral estoppel as to, but only as to, those matters or points which were in issue or controverted and upon the determination of which the initial judgment necessarily depended.

1 B Moore's, *supra*, ¶ 0.441 [2] at 3777 (footnotes omitted). There is no need to explore the intricacies of this doctrine or for us to determine what was ultimately proved in the Oklahoma and Ohio proceedings. See Evergreens v. Nunan, 141 F.2d 927 (C.A.2, 1944); 1 B Moore's, *supra*, ¶ 0.442 [2].

The Court need only note that the Crofters defendants were not involved in the Oklahoma proceeding and the S.E.C. was not involved in the state criminal action against these defendants. Nor can it seriously be maintained that Four Seasons was a privy of these defendants or that the State of Ohio functioned in such a capacity for the S.E.C. See Lawlor v. National Screen Service, *supra*, 349 U.S. at 329, 75 S.Ct. 865; Gratiot County State Bank v. Johnson, 249 U.S. 246, 39 S.Ct. 263, 63 L.Ed. 587 (1919); Restatement, Judgments, § 83, Comment a; also see Brigham v. Fayerweather, 140 Mass. 411, 5 N.E. 265 (1885); Griffin v. United States, 400 F.2d 612 (C.A.6, 1968); Clyde v. Hodge, 413 F.2d 48

(C.A.3, 1969); Davis v. Eide, 439 F.2d 1077 (C.A. 9, 1971); and see generally cases cited. 1 B Moore's Federal Practice, ¶ 0.411 [1]. Since the Crofters defendants were not in privity with the parties involved in the Oklahoma proceeding, and since the S.E.C. was not in privity with the parties involved in the Ohio proceeding, those proceedings cannot estop the present injunction suit against such defendants. Their contentions are therefore without merit and their motion for summary judgment on these grounds will therefore be denied.

(3)

Clark

Defendant Clark argues that Judge Bohanon's order of July 14, 1971, entered in the Oklahoma proceeding referred to above, estops the S.E.C. from continuing the present action against him. The legal principle which Clark asserts to be applicable is that: "The disallowance of a claim asserted by a party in a bankruptcy proceeding is a final judgment which may be asserted as a bar to further litigation respecting the same operable facts as between those who were parties to the bankruptcy, or their privies." Clark's memorandum in support of motion for summary judgment, at 81. As Clark's statement of the issue makes clear this Court must determine whether the S.E.C. was a party, within the meaning

of the doctrine of collateral estoppel, to the bankruptcy proceeding in Oklahoma.[22]

Section 208 of the Bankruptcy Act, 11 U.S.C. § 608 provides that the Securities & Exchange Commission may participate in corporate reorganization proceedings under Chapter X.[23] Two things must be

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[22] As we have previously noted, the doctrine of collateral estoppel precludes the relitigation of issues determined in a prior suit between the parties even though the second suit may involve an entirely different cause of action. *Res judicata*, however, only bars a second suit, between the same parties, on the same cause of action actually decided in the first suit. See Lawlor v. National Screen Service Corp., *supra*. It is obvious to this Court that the determination of common law fraud within the framework of a bankruptcy proceeding constitutes a different cause of action than Rule 10b-5 securities law fraud in the context of an S.E.C. injunction proceeding. See III Loss, Securities Regulation, 1430-1439; also see In the Matter of Four Seasons Nursing Centers of America, Inc., *supra*, Conclusions of Law No. 1 (July 14, 1971). Similarly, there are obvious differences between the present suit and the state criminal indictment against the Crofters principals charging violations of the state law prohibiting the making of false statements. For these reasons both the Crofters defendants in section (2), above, and Clark presently are raising issues which go only to the doctrine of collateral estoppel. *Res judicata* is not properly involved. The threshold question remaining before the Court, therefore, is whether the S.E.C. was a party to the Oklahoma proceeding under the doctrine of collateral estoppel.

[23] 11 U.S.C. § 608 reads:

> The Securities and Exchange Commission . . . may upon its own motion if approved by the judge, file a notice of its appearance in a proceeding under this chapter. Upon the filing of such a notice, the Commission shall be deemed to be a party in interest, with the right to be heard on all matters arising in such proceeding, and shall be deemed to have intervened in respect of all mat-

noted regarding this statutory provision: first, the right to permit S.E.C. to intervene under Chapter X is discretionary with the District Judge; second, the S.E.C., when permitted to so intervene, is not allowed a right of appeal from the District Court's determinations.

The limitations on the S.E.C.'s right to participate in Chapter X proceedings are consistent with the purpose and legislative history of Section 208. Professor Loss remarked that the Commission's "sole function [in Chapter X proceedings] is to act as an impartial representative of investors and expert advisor to the Courts in judicial reorganization proceedings." II Loss, *supra*, at 755. The Tenth Circuit has noted that the

> scope of the Commission's participation as a "party in interest" has been restricted by the legislative history of the Bankruptcy Act which indicates the function of the Commission in Chapter X proceedings is that of an impartial advisor, "in the role of amicus curiae." Senate hearings on H.R. 8046, 75th Cong.2nd Sess. 12 (1937-38) . . .

Securities & Exchange Commission v. Templar, 405 F.2d 126, 128 n. 4 (C.A.10, 1969); also see 6A Collier, Bankruptcy ¶ 9.27 at 324 (14 ed., 1965).

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ters in such proceeding with the same force and effect as if a petition for that purpose had been allowed by the judge; ***but the Commission may not appeal or file any petition for appeal in any such proceeding.*** (emphasis supplied)

While it is true that once admitted to a Chapter X proceeding the S.E.C. has the right to participate as a party, see Securities & Exchange Commission v. Krentzman, 397 F.2d 55 (C.A.5, 1968) and will be expected to observe the procedural rules of the forum, see Securities & Exchange Commission v. Bloomberg, 299 F.2d 315 (C.A.1, 1962) its participation is necessarily impinged by the limited role envisioned for the agency by Section 208. A Chapter X proceeding is fundamentally directed to the administration of the bankrupt estate and the evolution of a plan of reorganization. A proceeding of this kind cannot be seen as being in any way comparable to the S.E.C.'s general mission, which is to regulate the securities industry and enforce the policies of the federal securities laws. These dual functions of the Commission may occasionally be at variance and in tension with one another.

The Oklahoma proceeding involved Ohio's attempt to have the four million dollars it loaned Four Seasons removed from that corporation's bankrupt estate. The state's petition for reclamation alleged acts of fraud similar to those advanced at bar by the S.E.C. But the Court is unable to find any rationale, either logical or legal, which would put the S.E.C. to the burden of aligning itself with Ohio in the bankruptcy action and proving its case against Four Seasons in that proceeding. In its role as advisor to the District Court of Oklahoma the S.E.C. may have believed that the denial of Ohio's petition for reclamation was in the best interest of the bank-

rupt's creditors and investors. But this should not be permitted to estop the Commission, in its role as enforcer of the law, from seeking to have the conduct which led to the Chapter X proceeding, condemned and enjoined in another forum.

Additionally, we note that the Commission is not given the right to appeal from those Chapter X proceedings in which it intervenes. Although Professor Loss observes that the S.E.C. can circumvent this restriction either by joining in another party's appeal or by appealing as *amicus curiae*, II Loss. *supra*, at 756, we are reluctant to apply the doctrine of collateral estoppel to a party who has only a tenuous, unpredictable and discretionary right of appeal. See New York Telephone Co. v. Maltbie, 291 U.S. 645, 54 S.Ct. 443, 78 L.Ed. 1041 (1934).

On the basis of the foregoing authorities it is clear to this Court that the S.E.C.'s participation in Chapter X is primarily as an advisor and not as an adversary. There is no affidmative requirement that the S.E.C., once admitted to a Chapter X proceeding, try its injunction suit in that forum, even though some of the defendants it will later seek to enjoin are involved in the bankruptcy action. The rule should not be different even though some of the issues before the bankruptcy forum are similar to those that will be raised later by the S.E.C. in a different forum. See Rachel v. Hill, 435 F.2d 59 (C.A.5, 1970); Securities & Exchange Commission v. Krentzman, *supra* (1968). Under these circumstances, and especially where the causes of action and the degree of re-

quired proof are so dissimilar, the doctrine of collateral estoppel is not properly invoked in this forum against the S.E.C. by defendant Clark. See Evergreens v. Nunan, 141 F.2d 927 (C.A.2, 1944); Glass v. U. S. Rubber Co., 382 F.2d 378 (C.A.10, 1967); Technograph Printed Circuits Ltd. v. United States, 372 F.2d 969, 178 Ct.Cl. 543 (1967); Rachel v. Hill, *supra*. Defendant Clark's motion for summary judgment on this ground will therefore be denied.

(d)

Propriety of Injunctive Relief

It is the opinion of this Court that there is sufficient evidence now before us which could support the issuance of an injunction against all of the defendants. Sixteen of the eighteen remaining defendants (all excepting LCM and Lore) defendant King Resources having been dismissed, *supra*, at p. 258, have been found to be in violation of Sections 17(a)(1) and (3) and Rule 10b-5(1) and (3) as detailed in section (a) of this Opinion at pp. 251-257, *supra*. Defendants LCM and Lore have been found to be in violation of the same statutory provisions in respect to Counts three and four of the Complaint. See section (b) of this Opinion at p. 256, *supra*. In addition to these specific findings the Court notes that the evidence adduced by plaintiff Commission, regarding the Whittaker-Vector transactions and Trueblood's letter to Consolidated's shareholders (*supra* at pp. 244-245 and p. 248, respectively) makes out

a *prima facie* case which would justify the issuance of an injunction as to these activities as well.

The moving defendants argue that the Court should not grant plaintiff's motion for preliminary injunction because of a lack of "equity". Defendant Clark, who of the defendants has developed this argument most comprehensively, contends that an injunction against him would be improper for the following reasons: first, there has been a cessation of his unlawful conduct during the past two years; second, his past violations were not flagrant; third, the plaintiff has failed to demonstrate that Clark has a propensity or natural inclination to violate the securities laws; and fourth, the general equities tip in his favor. The other moving defendants assert similar arguments.

Contentions of this sort are often made in suits brought under the injunction provisions of the securities law insofar as injunctions are directed to the discretion of the trial judge. Professor Loss has remarked in this regard that:

> The main problem in most actions for injunction instituted by the S.E.C. is whether there is "equity" which is usually reduced to the question whether the violations occurred recently enough to warrant the conclusion that there is a threat that the illegal practices will be resumed . . .
>
> The ultimate test is whether the defendant's past conduct indicates—under all the circumstances and not merely in view of the time which has elapsed since the last violation—that there is a

reasonable likelihood of further violations in the future.

III Loss, Securities Regulation, 1975-1976 (2d ed. 1961). This standard makes it clear that courts should not look solely at the period of time that has elapsed between a violation and an ultimate ruling. This Court is unwilling that a crowded docket be allowed to make activities which were improper in 1969-1970 acceptable in 1972.

It is well established that "illegal past conduct gives rise to the inference that there is a reasonable likelihood of future violations" of the securities laws. Securities & Exchange Commission v. Globus International Ltd., 320 F.Supp. 158, 160 (S.D.N.Y.1970); also see Otis & Co. v. Securities & Exchange Commission, 106 F.2d 579 (C.A.6, 1939); Securities & Exchange Commission v. Keller Corporation, 323 F.2d 397 (C.A.7, 1963); Securities & Exchange Commission v. Culpepper, *supra*; Securities & Exchange Commission v. Manor Nursing Centers, Inc., 458 F.2d 1082 (C.A.2, 1972); Tanzer v. Huffiness, 408 F.2d 42, 43 n. 1 (C.A.3, 1969). Once the plaintiff Commission establishes, as they have here, that such violations have occurred, the burden of showing that there is no reasonable expectation that illegal activities will be repeated shifts to the defendants. Securities & Exchange Commission v. Culpepper, *supra*, 270 F.2d at 249. That burden is "a heavy one" and the defendants have failed to sustain it here. See United States v. W. T. Grant Co., 345 U.S. 629, 633, 73 S.Ct. 894, 97 L.Ed. 1303

(1953); Securities & Exchange Commission v. Culpepper, *supra*; Securities & Exchange Commission v. Boren, 283 F.2d 312 (C.A.2, 1960); Securities & Exchange Commission v. Broadwall Securities Inc., 240 F.Supp. 962 (S.D.N.Y., 1965).

Viewing all the circumstances of this case, we conclude that in light of defendants' past cavalier activities there is reasonable likelihood that the defendants will, in the future, engage in similar conduct.

Once a court determines that these exists a reasonable likelihood of future violations of the securities laws, cessation of the unlawful conduct is not a bar to the issuance of an injunction. See United States v. W. T. Grant Co., *supra;* Hecht Co. v. Bowles, 321 U.S. 321, 64 S.Ct. 587, 88 L.Ed. 754 (1944); Securities & Exchange Commission v. Pearson, 426 F.2d 1339 (C.A.10, 1970); Securities & Exchange Commission v. Golconda Mining Co., 291 F.Supp. 125 (S.D.N.Y., 1968); Securities & Exchange Commission v. Electronics Security Corp., 217 F.Supp. 831 (D.Minn., 1963); Securities & Exchange Commission v. Cohn, 216 F.Supp. 636 (D.N.J., 1963); Securities & Exchange Commission v. Scott Taylor & Co., 183 F.Supp. 904 (S.D.N.Y., 1959). In addition, it is well established that proof of scienter is not necessary to justify preliminary injunctive relief. See Securities & Exchange Commission v. Capital Gains Research Bureau, *supra*, 375 U.S. at 192-194, 84 S.Ct. 275, 11 L.Ed.2d 237; Securities & Exchange Commission v. Pearson, *supra*, 416 F.2d at

1343. Finally, this Court notes that in actions brought by a government agency to enforce by injunction compliance with a statute administered by that agency, "courts go much further to give relief than they are accustomed to go when only private interests are involved." Federal Trade Commission v. Rhodes Pharmacal Co., 191 F.2d 744 (C.A.7, 1951). There is "implied a different standard for S.E.C. actions than for private suits seeking damages." Securities & Exchange Commission v. Fifth Avenue Coach Lines, Inc., 435 F.2d 510 (C.A.2, 1970). In such actions the Court must balance the likelihood of repetition of unlawful conduct with the "legislative intent to leave as few loopholes as possible." Securities & Exchange Commission v. North American Research & Development Corp., *supra*, 424 F.2d at 82.

To reiterate the Court's position, it is our conclusion that a reasonable likelihood remains that the defendants, unless enjoined, will commit violations of the securities laws in the future. However, while some courts have granted preliminary injunctions before hearing, see Securities & Exchange Commission v. Globus International, Ltd., *supra*, we think the more proper course is to postpone issuance pending a hearing on the motion. See Securities & Exchange Commission v. Frank, 388 F.2d 486 (C.A.2, 1968); Securities & Exchange Commission v. Barraco, *supra*; Securities & Exchange Commission v. Great American Industries, *supra*. Accordingly, the defendants will be temporarily restrained from violating Sections

17(a) and 10(b) of the securities laws pending a hearing on plaintiff's motion for a preliminary injunction. Such hearing will be consolidated, pursuant to Rule 65(a)(2), Fed.R.Civ.P., with the trial on the merits for a permanent injunction. However, those issues decided in this Opinion, as a matter of law, will not be deemed before the Court on hearing on plaintiff's motion. Evidence will be heard at said hearing on the S.E.C.'s charges that the financial data submitted to N.C.O. by Four Seasons was substantially overstated and misleading.

The Court is not yet in a position to decide the issue of whether certain defendants violated Section 17(a)(2) and Rule 10b-5(2) by failing to disclose their intent to reloan substantial amounts of the money borrowed from Ohio to third persons or to other defendants. Since the facts regarding this reloaning activity are apparent on the face of the record the Court will decide this question as a matter of law, upon submission, within thirty (30) days of this Opinion and Order, of supplemental memoranda by the parties affected by this question. Upon timely motion and for good cause shown, the Court will hear limited testimony on this point as well, but expects such evidence as well as all other evidence to be terse and to the point.

The plaintiff Commission and the Crofters defendants shall also submit supplemental memoranda, within thirty (30) days of the filing herein on whether these defendants violated Section 15(a) of

the Exchange Act of 1934 by failing to register as brokers as alleged in Count V of the complaint. Limited testimony upon this point, as well, will be heard, again upon motion and for good cause shown.

Several civil damage suits have been filed by the State of Ohio against some of the same defendants now before the Court. See State of Ohio v. Crofters, Inc., et al., Civil No. 72-81 (S.D.Ohio, E.D.); State of Ohio v. Crofters Inc., et al., Civil No. 72-138 (S.D. Ohio, E.D.). Those cases present claims which are distinct from the ones we have decided today. Nothing contained herein shall be construed as intimating a view on the final resolution of those cases or as necessarily affecting the rights of the parties in other proceedings now pending before the Court.

Wherefore, for the reasons set forth above, the S.E.C.'s motion for a preliminary injunction, as deemed a motion for a temporary restraining order, within the meaning of the National Securities Acts, see III Loss, *supra*, at pp. 1977-1980, is hereby granted as against all defendants at bar. Said defendants are hereby temporarily restrained from violating the provisions of Section 17(a)(1) and (3) of the Securities Act of 1933 and Section 10(b) and Rule 10b-5(1) and (3) thereunder of the Exchange Act of 1934. The motion for summary judgment of defendant King Resources is meritorious and is hereby granted. Defendant King Resources is therefore dismissed from this action. The motions for summary judgment of defendants Crofters, Deegee, Regency Acceptance, Donahue, Griffith, Groban, Consoli-

dated, Trueblood, Kerr, Clark and Coffey are without merit and are hereby denied. The cross motions for summary judgment of the S.E.C. as against defendants Consolidated, Trueblood, Kerr and Clark are, to the extent indicated above, meritorious and are granted in part.

It is so ordered.

On Applications for Stay

This matter is before the Court on the applications to stay proceedings filed by defendants John M. King and William V. Coffey. These defendants have filed, contemporaneously with the applications herein, notices of appeal to the Court of Appeals for the Sixth Circuit from our Temporary Restraining Order of August 10, 1972. Plaintiff Securities and Exchange Commission (SEC) have informed this Court of their intent to oppose said applications to stay proceedings.

We note that we have set this matter in accordance with our Order of August 10, 1972, for a consolidated hearing, pursuant to Rule 65(a) Fed.R.Civ.Pro., on the plaintiff's application for a preliminary and permanent injunction. This hearing is now scheduled for October 10, 1972. The Court expects to dispose at that time of certain questions of a factual nature relating to these moving defendants which could not have been disposed of in our earlier Order.

Defendants King and Coffey have argued that our Order of August 10, 1972, was, in effect, a

preliminary injunction. Assuming *arguendo* that their contention is correct, their appeal from that Order is still interlocutory in nature and reviewable on an abuse of discretion rubric. See Bradley v. Milliken, 433 F.2d 897 (C.A.6 1970); Cowden Mfg. Co. v. Koratron Co., 422 F.2d 371 (C.A.6 1970), cert. denied 398 U.S. 959, 90 S.Ct. 2173, 26 L.Ed.2d 544 (1970); Consolidation Coal Co. v. Disabled Miners of So. W. Va., 442 F.2d 1261 (C.A.4 1971).

While ordinarily the filing of a notice of appeal operates to transfer jurisdiction of a case from the District Court to the Court of Appeals, see Hogg v. United States, 411 F.2d 578 (C.A.6 1969); Cleveland-Cliffs Iron Co. v. Grosse Ile Bridge Co., 239 F.Supp. 872 (S.D.Mich.E.D. 1964), the rule is otherwise in situations involving interlocutory appeals from preliminary injunctions. See Rule 62(a)(c). Fed. R.Civ.Pro.; Foote v. Parsons Non-Skid Co., 196 F. 951 (C.A.6 1912); Janousek v. Doyle, 313 F.2d 916 (C.A.7 1963). As the Court noted in Foote v. Parsons Non-Skid Co., *supra*, relying on the predecessor of Rule 62(a), Fed.R.Civ.Pro.:

> "[a]n appeal from a motion granting a preliminary injunction does not have the effect to remove the cause to this court, but the cause generally remains in the court below, and continues in the control of that court."

Also see Janousek v. Doyle, *supra*, 313 F.2d at 920-921, and cases cited therein.

This Court therefore has the discretion of granting the stay requested in defendants' applications.

In exercising our discretion, under Rule 62(c), to stay the proceedings as to matters not currently pending before the Circuit Court, we are of the opinion that defendants' applications should be denied. The factual questions still before us should be resolved as they are not in a posture, at present, for disposition by an appellate court. If resolved against defendants herein, these remaining issues could be, theoretically, adequate to support a permanent injunction regardless of the outcome of matters decided in our Order of August 10, 1972, which are now pending before the Sixth Circuit.

Our denial of defendants' applications for stay is consistent with the rule that "an appeal from the denial or granting of a temporary injunction should not ordinarily delay the final trial of the case on its merits," Nalco Chemical Co. v. Hall, 347 F.2d 90, 92 (C.A.5 1965); United States v. Lynd, 321 F.2d 26 (C.A.5 1963); also see Mailloux v. Kiley, 436 F.2d 565 (C.A.1 1971); Securities and Exchange Commission v. Charles Plohn & Co., 433 F.2d 376 (C.A.2 1970); Hamer v. Campbell, 358 F.2d 215 (C.A.5 1966), cert. denied 385 U.S. 851, 87 S.Ct. 76, 17 L.Ed.2d 79 (1966); and with the general and strong federal policy against the allowance of "piecemeal" appeals. See Switzerland Cheese Association v. E. Horne's Market, 385 U.S. 23, 87 S.Ct. 193, 17 L. Ed.2d 23 (1966); Andrews v. United States, 373 U.S. 334, 83 S.Ct. 1236, 10 L.Ed.2d 383 (1963); Baltimore Contractors, Inc. v. Bodinger, 348 U.S. 176, 75 S.Ct. 249, 9 L.Ed. 233 (1955).

Accordingly, defendants' applications for stay of proceedings are without merit and the same shall be and are hereby denied.

It is so ordered.

APPENDIX C

IN THE DISTRICT COURT
OF THE UNITED STATES FOR THE
SOUTHERN DISTRICT OF OHIO
EASTERN DIVISION

Civil No. 70-351

SECURITIES AND EXCHANGE COMMISSION, PLAINTIFF

v.

CROFTERS, INC., ET AL, DEFENDANTS

ORDER

This matter came on for trial on the motion of plaintiff Securities and Exchange Commission (S.E.C.) for a final order of permanent injunction against defendants John M. King and William V. Coffey. These defendants were formerly the chairman of the board and executive vice-president, respectively, of former defendant herein, King Resources Company.[1] The Court has carefully considered the complaint, answers, depositions, affidavits and briefs filed herein and the evidence adduced at trial on behalf of plaintiff and said defendants.

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[1] King Resources Company was dismissed from this action, on *res judicata* grounds, by our Opinion and Order of August 10, 1972. See *S.E.C.* v. *Crofters,* —— F.Supp. —— (S.D. Ohio E.D. 1972) at 29-31, 42 (slip opinion).

Upon consideration and being fully advised in the premises, the Court concludes, for the reasons as more fully set forth in our Opinion and Order of August 10, 1972, that defendants King and Coffey engaged in or are legally responsible for acts, including those which culminated in obtaining for King Resources Company a rating of "prime" from National Credit Office (N.C.O.) which was subsequently employed in connection with notes of term in excess of 270 days. These acts were and are in contravention of Section 17(a)(1) and (3) of the Securities Act of 1933, 15 U.S.C. § 77q(a), and Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) and Rule 10b-5(1) and (3) promulgated thereunder, 17 C.F.R. 240.10b-5. Consequently, in weighing the equities and authorities, it is this Court's determination that defendants King [2] and Coffey should be permanently enjoined from further violations of the federal securities laws.

Therefore, the tentative findings and conclusions of our earlier Order are, insofar as applicable to the defendants at bar, hereby adopted and made perma-

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[2] Defendant King has defended the complaint against him primarily on the ground that, as chairman of King Resources' Board of Directors, he was more involved with raising funds overseas than he was with tending to the day to day domestic operations of his company, including its transactions with NC.O. See Tr. at 8-12. This argument must be rejected. As the untimely death of our 33rd President has so recently had cause to remind us, the "buck" of responsibility must stop somewhere and more often than not, with the chief executive officers of our business and governmental institutions.

nent. As such they shall constitute our findings of fact and conclusions of law filed in conformity with Rule 52(a), Fed. R. Civ. P. See, in addition to the authorities cited in our earlier Opinion, *Sanders* v. *John Nuveen & Co., Inc.*, 463 F.2d 1075 (C.A. 1972); Note, *The Commercial Paper Market and the Securities Law*, 39 U. of Chi. L. Rev. 362, 364 (1972).

Deciding this case as we do, it becomes unnecessary to consider other issues raised by the complaint, including the financial condition of King Resources at the time the Ohio loans were consummated and the reloaning of a portion of these funds to third persons.

Plaintiff Commission shall, within twenty (20) days of the entry of this Order, submit a form of permanent injunction against defendants King and Coffey which shall be consistent with the views expressed herein and in our Order of August 10, 1972.

It is so ORDERED.

/s/ Carl B. Rubin
United States District Judge

Filed December 29, 1972

APPENDIX D

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

Nos. 73-1396
73-1397

SECURITIES AND EXCHANGE COMMISSION,
PLAINTIFF-APPELLEE

vs.

JOHN M. KING AND WILLIAM V. COFFEY,
DEFENDANTS-APPELLANTS

Before: CELEBREZZE, Circuit Judge, McALLISTER, Senior Circuit Judge, and WILSON, District Judge.

JUDGMENT

APPEAL from the United States District Court for the Southern District of Ohio.

THIS CAUSE came on to be heard on the record from the United States District Court for the Southern District of Ohio and was argued by counsel.

ON CONSIDERATION WHEREOF It is now here ordered and adjudged by this Court that the judgment of the said District Court in this cause be and the same is hereby reversed and the case is remanded for further proceedings.

It is further ordered that Defendants-Appellants recover from Plaintiff-Appellee, the costs on appeal, as itemized below, and that execution therefor issue out of said District Court.

ENTERED BY ORDER OF THE COURT

/s/ John P. Hehman
Clerk

A True Copy.

Attest:

John P. Hehman
Clerk

March 28, 1974

APPENDIX E

UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

Nos. 73-1396 & 73-1397

[Filed Jul. 2, 1974, John P. Hehman, Clerk]

SECURITIES AND EXCHANGE COMMISSION,
PLAINTIFF-APPELLEE

v.

WILLIAM V. COFFEY, DEFENDANT-APPELLANT

and

JOHN M. KING, DEFENDANT-APPELLANT

ORDER

Before CELEBREEZE, Circuit Judge; McALLISTER, Senior Circuit Judge; and WILSON,* District Judge.

Upon due consideration this court is of the opinion that no clarification of its Opinion is necessary.

Accordingly, Appellee's motion for rehearing and clarification of opinion be and the same is hereby denied.

It is so ordered.

ENTERED BY ORDER OF THE COURT

/s/ John P. Hehman
Clerk

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* The Honorable Frank W. Wilson, Chief Judge, United States District Court for the Eastern District of Tennessee, sitting by designation.

APPENDIX F

The Securities Act of 1933, 48 Stat. 74, as amended, 15 U.S.C. 77a, *et seq.*

Section 17(a), 15 U.S.C. 77q(a)

It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice or course of business which operates or would operate as a fraud or deceit upon the purchaser.

Section 20(b), 15 U.S.C. 77t(b)

Whenever it shall appear to the Commission that any person is engaged or about to engage in any acts or practices which constitute or will constitute a violation of the provisions of this subchapter, or of any rule or regulation prescribed under authority thereof, it may in its discretion, bring an action in any district court of the United States or United States court of any Territory, to enjoin such acts or prac-

tices, and upon a proper showing a permanent or temporary injunction or restraining order shall be granted without bond. The Commission may transmit such evidence as may be available concerning such acts or practices to the Attorney General who may, in his discretion, institute the necessary criminal proceedings under this subchapter. Any such criminal proceeding may be brought either in the district wherein the transmittal of the prospectus or security complained of begins, or in the district wherein such prospectus or security is received.

The Securities Exchange Act of 1934, 48 Stat. 881, as amended, 15 U.S.C. 78a, *et seq.*

Section 10(b), 15 U.S.C. 78j(b)

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Section 21(e), 15 U.S.C. 78u(e)

Whenever it shall appear to the Commission that any person is engaged or about to engage in any acts or practices which constitute or will constitute

a violation of the provisions of this chapter, or of any rule or regulation thereunder, it may in its discretion bring an action in the proper district court of the United States or the United States courts of any Territory or other place subject to the jurisdiction of the United States, to enjoin such acts or practices, and upon a proper showing a permanent or temporary injunction or restraining order shall be granted without bond. The Commission may transmit such evidence as may be available concerning such acts or practices to the Attorney General, who may, in his discretion, institute the necessary criminal proceedings under this chapter.

Rule 10b-5, 17 C.F.R. 240.10b-5

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

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